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Accounting News And Trends

The Fund Statement

The increased popularity of the statement showing the source and application of funds is shown by a survey reported in THE LOUISIANA CPA (October 1957). At the present time 61 per cent of the members replying to the questionnaire include such a statement in nearly every report they prepare. The survey also showed that ten years ago only 32 per cent prepared this type of statement.

The titles used for the statement vary but the most popular (over 42 per cent) was "Statement of Sources and Applications of Funds." Practically all the titles (92 per cent) contain the word "fund." One notable exception was furnished by a straight-talking CPA who entitled his product "Where Got—Where Gone Statement."

Drop Material

The following ruling of its Committee on Professional Ethics was published in its bulletin by the Michigan Association of CPAs (January 1958).

"A member shall not directly or indirectly cause or allow to be issued or released material commonly known as drop material which bears his name as a certified public accountant, or bears his firm name when it is a firm engaged in public accounting. Drop material consists of items such as pencils, rulers, matches, calendars, scratch pads, note paper, memorandum books and any other material designed to gain recognition of the name of the issuer." (Rule 10)

Practitioners become irritated when material bearing the name of another practitioner comes, directly or indirectly, into the possession of a client. Such material is a common form of advertising for commercial enterprises. The Committee made this ruling in an attempt to "reduce petty irritations within the profession and to avoid use of a form of advertising which appears to be beneath the dignity of the profession."

Softening the Disclaimer

An article of particular interest to CPAs with smaller clients appears in the February 1958 BULLETIN of the Georgia Society of CPAs ("Application of AIA Bulletin No. 23 to Audits of Small Businesses" by Leo J. Lèonard).

In one section of this article the author discusses the report prepared by a small practitioner who has engaged in considerable analysis of the books and records of his client in order to be sure that all necessary adjustments are made for the preparation of financial statements and tax returns. In addition, this accountant has been working with this client over a period of years and maintains an almost continuous contact with the business. A disclaimer of opinion must, however, be rendered because the examination was not of sufficient scope. But since the analysis of the records has been quite extensive, there is a tendency for the accountant to soften this disclaimer with some such statement

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, C.P.A. *and member of the New York Bar. He is presently serving as chairman of our Society's Committee on Members in the Field of Education.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

as: "However our examination discloses nothing that would cause us to question in any material respect the data presented herein."

The author questions the addition of this phrase, pointing out that if a CPA states he has examined the books and records and has found nothing that would cause him to question in any material respect the data presented in the statements, then most readers would be inclined to consider the disclaimer a mere technicality. Since the purpose of the disclaimer is to require that the CPA clearly state the degree of responsibility he is taking for the statement, it seems that such statements should certainly never be used where appropriate or required auditing procedures were not applied no matter how extensive an analysis of the records was made or how carefully the statements were prepared.

The fact that some auditing procedures were employed and others omitted does not really alter the situation. The CPA should make it clear that his examination was not of sufficient scope to constitute an audit such as would enable him to express an overall opinion.

The author suggests this additional wording if the CPA does not wish to limit himself to a simple disclaimer: "Our examination was not of sufficient scope as would be required to express any opinion as to the fairness of the

representations contained in the statements. Our review of the records, however, did not indicate the existence of any matters requiring correction other than those for which we made adjustments in preparing the statements."

Influence of the Law On Accounting Reports

In 1955 the law of Ohio was revised to require a corporation which acquires its own stock, whether or not the stock is retired, to reduce the stated value of the *class* of shares acquired by the stated value of the acquired stock. The excess of the cost of the stock acquired over its stated value is charged to the appropriate surplus account(s); any excess of stated value over cost is credited to capital surplus. The law provides that "Profits and gains from transactions in shares of the corporation do not constitute a part of earned surplus; losses from such transactions may be charged against capital surplus resulting from profits and gains from such transactions, and any balance of losses shall be charged against earned surplus."

The Research Department of Arthur Young & Company reports in that company's Journal (January 1958) that of 15 Ohio corporations having treasury stock, ten changed their accounting to comply with this revision. Of the remainder, two had previously treated treasury stock as a reduction of the stated value of outstanding shares, and three continued to treat treasury stock as a deduction at cost from the total stockholders' equity.

Junior Accountants and Professional Growth

Many firms offer ample opportunity to the junior accountant to achieve professional growth and development but it is the efforts of the ambitious junior on his own behalf that will determine the rate of his advancement. Certain suggestions to help such a junior are made by Charles G. Walker in "Responsibility of the Junior Accountant For His Professional Development" (ARTHUR YOUNG JOURNAL, January 1958).

While in the office, maximum use of unassigned time should be made to pursue a definite review and study program. The office library will supply technical magazines, Institute bulletins and many reference books. A further study of the firm's handbook and internal control questionnaires repays the effort expended. Finally, the working papers and reports of actual firm audits can be reviewed and analyzed for form and content.

While working on audits, the junior might well consider these points:

1. Practice decision making. For every problem the junior brings to the senior's attention, a decision, even if only mentally, should be reached by the junior. He should then review his own decision in the light of the decision reached by the senior.

2. Gather complete facts. It should be a matter of pride with a junior to present all pertinent facts and questions on a particular matter to the senior at one time. He should so group his questions and his facts that a senior can review them once and not have to reconsider the matter at a later time.

3. Review own working papers before submission to the senior, considering such items as:

(a) Are they mechanically complete, date, initials, etc.?

(b) Are figures or other facts cross-referenced or indexed and do computations tie into other work papers?

(c) Has there been needless work? Could the job be done better next year by changing procedures or redesigning some workpapers?

(d) Could the client's staff have assisted in the preparation of more of the workpapers?

4. Review the "why." The junior should critically consider each procedure he followed in the audit to make

sure he knows the reason behind it. He may have to consult with the senior (probably during a coffee break, at lunch, or after working hours) or engage in outside reading, but to advance the junior must have complete knowledge of these reasons.

While off the job it is necessary for the junior to participate in professional activities sponsored by the AICPA and state societies. This is the best way to keep abreast of current developments and to be stimulated by the thinking of fellow members of the profession.

Reporting Practices

A comparison of financial reporting practices in the United States and Canada reveals some interesting differences. ACCOUNTING TRENDS AND TECHNIQUES (Eleventh Edition, 1957) and FINANCIAL REPORTING IN CANADA (Second Edition, 1957) prepared by the national accounting organizations of the respective countries, summarize current reporting practices. Together, these books offer nearly 400 pages of tables, descriptions, and comments based upon the reports of 300 Canadian and 600 U.S. corporations. A few items noted were:

1. *Title of Income Statement.* The title "profit and loss statement," although declining in Canada, is still used by 61 per cent of the companies. In the U.S. only about 7 per cent use this title while nearly 60 per cent use the term *income statement.*

2. *Earned Surplus.* In Canada nearly two-thirds of the companies continue to use the designation "earned surplus" while in the U.S. less than 40 per cent use this term. The phrase "retained earnings" has come to be used in over 50 per cent of the reports of U.S. companies.

3. *Report Titles.* In Canada the title of "auditor's report" is used practically exclusively. In the U. S. this term is used only about 17 per cent of the time. Here there is no uniformity, but "accountant's report" is the most popular.

An Adirondack View

The BD Game. Listen, my CPA readers, and you shall hear, not about the activities one night of Paul Revere, but about an evening spent playing a new Business Decision Game. It was quite a ride.

You may have read about this game in a recent issue of FORTUNE. Military war games seem to be the father of the idea. The AMA, and others, are mothering it. And here in the Adirondacks, where the AMA is where Trudeau San. was, the game is now a lusty youngster.

Eighteen local men played this BD game on the 9th of April,—three competing companies with six men in each. We started with our company's financial and production facts, and a few normal facts about the industry and our competitors. Each quarter we got a report and made decisions for the next quarter—production volume, sales price, plant expansion, marketing expense, product research and development, market research information—six basic things. Ten minutes for each group of six men to decide and agree. Then the decisions of each company went to the game leaders, cards were punched, the IBM hummed, the printer clacked. Meanwhile, each team of six brains got ready to get its results and do some more decision making.

Yes, you get a real ride. And, like Paul Revere, you have to think and act fast—and minimize the talk.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
"The Adirondack Chapter"

Letters to the Editor

Some Practical Considerations on Union Welfare Fund Accounting

I have read the article by Mr. Raymond Buchbinder entitled "Union Welfare Funds" (THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, February 1958) with a great deal of interest since I am the administrator of a national health and welfare fund which is operated by an international labor union. All in all, it is quite comprehensive and accurate, but I would like to offer a few modifications based on my experience in this field.

I have been informed by the New York State Compensation Board that where an insurance carrier is authorized to provide disability insurance coverage, the health and welfare fund is not required to file Form DB 801 and the employers are not required to file Form DB 802. I understand that the insurance carrier is required, in such cases, to file their own form disclosing pertinent facts for such coverage. This is true even if the health and welfare fund is self-insured for other benefits under their plan.

The section of the article on "Taxes" discusses the question of filing Form 990 for welfare funds, but it is not very clear as to how it should be done. The form for 1957 permits health and welfare funds and local union operating results to be both reported on the same Form 990. Previously, each had to file separately. This, of course, applies only when the local union or the national or international union also operates the health and welfare fund.

A point that is very important in the administration of a health and welfare fund is how to prevent applicants for benefits from receiving both unemployment insurance (or compensation) and benefits under a welfare plan. If possible, I try to obtain an applicant's unemployment insurance book, or contact the employer's bookkeeper in a questionable case, but the problem does exist and this is one point on which I would invite further discussion.

Most of the union welfare funds in operation today are administered by local unions. I am currently in the process of setting up a national health and welfare fund comprising as many local union welfare funds as can expeditiously be affiliated at this time. The problems in this field are numerous and involved and I hope at some future date to prepare a technical article on the subject.

JACK N. TRAGER, CPA
New York, N. Y.

Union Welfare Funds and the Taxability of Vacation Payments

Raymond Buchbinder is to be congratulated for his scholarly article in the February, 1958 issue dealing with union welfare funds. He covered the subject thoroughly in a specialized field of auditing which has long needed an article of this calibre.

I should like to supplement Mr. Buchbinder's statement that the amount that the employee receives in benefits does not constitute taxable income to him. This is true with respect to medical benefits received by employees. However, there are plans in existence which provide for the payment by a vacation fund of vacation allowances to employees, and the Internal Revenue Service has recently ruled (Revenue Ruling 57-316) that under certain circumstances such payments received by the

employee constitute additional wages for federal employment tax purposes.

Some further interesting points are brought out in this ruling concerning the employer's tax responsibility and liability as a result of these payments. According to this ruling, the trustees of the vacation fund are responsible for the withholding of Federal income tax from the vacation allowances paid to each employee, but the persons for whom the recipients of vacation allowances actually performed the services are responsible for the payment of the taxes under the Federal Insurance Contributions Act and the Federal Unemployment Tax Act.

ROBERT KRANZLER, CPA
Hempstead, N. Y.

Workmen's Compensation Insurance, Taxation and Union Welfare Funds

Some Comments by the Author

In the letter written by Mr. Jack N. Trager the question is raised as to the requirement that the plan qualify with the Workmen's Compensation Board (N. Y.) by filing Form DB 801 and the contributing employers filing form DB 802. I rechecked this with the Workmen's Compensation Board and they concurred that the manner in which I stated it, is in accordance with the law. Where a policy holder is other than the employer, the policy holder must qualify by filing DB 801 and the employer files DB 802. Failure to do so would require the employers to carry their own coverage, which could be a duplication of the welfare plan's coverage.

In answer to his statement as to Form 990, an employer-employee welfare plan is a separate entity from the union or its employers and receives its own exemption under Sec. 501 (c)(9). Its funds, as stated in my article, must be kept separate in accordance with the Taft Hartley Act and, therefore, the Form 990 which is filed can only be

for the plan itself and cannot include any of the union's figures. However, if Mr. Trager is referring to a union which operates its own plan as a part of the union itself, then it would file Form 990 for the complete union operation.

In Mr. Robert Kranzler's letter mention is made of the taxability of vacation allowances. He is correct in that such amounts are taxable as wages to the recipient, but they are paid from a separate fund, usually a vacation fund, and not a health and welfare plan. The Treasury Department does not consider a vacation plan an exempt organization under Sec. 501 and requires that funds file as a trust. It is doubtful under their present rulings that a welfare fund could receive an exemption and include among its welfare benefits, payments for vacation allowances.

RAYMOND BUCHBINDER, CPA
New York, N. Y.

Uniform Reporting Forms for Employee Welfare Funds

To accountants confronted at this time of the year with a myriad of forms required by various federal, state and local authorities, it may come as welcome news to learn that governmental agencies do have an interest in uniformity of reporting procedures.

A number of states have recently enacted legislation dealing with employee welfare funds. The National Association of Insurance Commissioners now is considering adoption of uniform blanks to be used in states which have passed such legislation. The blanks under consideration are modelled after those presently used by the New York State Insurance and Banking Departments for welfare funds which come under their jurisdiction.

Our Society's Committee on Employee Welfare Plans and Funds has been invited to make suggestions as to the pro-

posed forms. In view of the possibility that additional states may join the ranks of those which have enacted welfare fund legislation and that funds not now covered by existing legislation may be affected by future laws, the importance of uniform reporting requirements can be appreciated.

Accordingly, our Committee will welcome any comments and suggestions from interested members, particularly those who have had experience in preparing such reports.

ISIDORE PLATKIN, CPA
Chairman, Committee on Employee Welfare Plans and Funds

The Small Client and State Taxes

As practicing accountants we are very prone in our tax thinking on client matters to concentrate on the impact of Federal taxes. Yet some attention to our own New York State taxes can reward our effort handsomely. Our smaller clients would benefit, especially those whose unincorporated businesses have an established earnings record.

For the smaller client in the service industry, such as the commercial artist, the photographer, the insurance broker, and others, a corporation is not usually thought of as an advantage; yet a brief glance at the following tabular comparison reveals favorable tax savings from the corporate form of doing business:

INCOME LEVEL	UNINCORPORATED BUSINESS TAX	FRANCHISE TAX
$10,000	$120	$25 minimum
15,000	280	25 minimum
20,000	440	82.50

For the purpose of this discussion, it is assumed that the client's entire unincorporated earnings become his officer's salary when incorporated. In this event, the computation of the franchise tax would be based on corporate net income plus officer's compensation. While the officer's salary can be challenged, it is

not likely where there is a history of similar earnings prior to incorporation.

From the above summary it appears that an appreciable part of the expense of incorporating can be recovered in the first year's tax saving. The following are computations of both taxes at the $20,000 level.

UNINCORPORATED BUSINESS TAX

	$
Profit Before compensation to owner	20,000
Less owner's statutory salary allowance (20% x $20,000 or $5,000 whichever is the lesser)	4,000
	16,000
Unincorporated exemption	5,000
Taxable balance	11,000
Tax at 4%	440

FRANCHISE TAX

(Alternate computation where Officer's salary is material in amount)

	$
Net income per tax return	—0—
Add officer's salary (previously deducted from net income)	20,000
	20,000
Statutory allowance	15,000
	5,000
Statutory amount subject to tax at statutory percent—30%	1,500
Tax at 5½%	82.50

Not to be overlooked is the easier payment plan of the franchise tax. For the calendar year organization, the unincorporated tax is due April 15th in its entirety, while the franchise report is due May 15th with one-half of the tax or the $25 minimum tax; the balance is due December 1st.

Those service businesses which have sought the professional exemption from the unincorporated tax and have failed to secure that exemption from the State Tax Commission can well study this approach for tax minimization.

SIDNEY H. RAND, CPA
New York, N. Y.

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

HELP WANTED

Los Angeles Tax Law Firm wants young attorney-CPA who ranked high in law school class. Submit resume to Box 1383.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd St., N. Y. C., telephone LOngacre 4-1740.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private, office management, financial statements, internal controls, credits and collections, taxes. Box 1384.

CPA, age 31, nine years public, good references and experience, seeks position leading to junior partnership, capital available. Box 1390.

CPA, 11 years experience, desires per diem work in Queens-Nassau counties. Box 1394.

CPA, 35, 15 years diversified experience, seeks per diem engagements, available 6-8 days monthly. Box 1396.

CPA, N. Y., N. J., AICPA, M.B.A., Society member, fifteen years public accounting and controllership, seeks position as heavy senior. Box 1398.

CPA, Society member, AICPA, seeks per diem work Metropolitan area of New York, age 39, 15 years experience. Box 1399.

Tax Accountant, attorney, M.B.A., former revenue agent, tax planner, research, reviewer, excellent background, seeks tax position with potential. Box 1401.

Accounting Major wishes summer work, June 5—September 15, in CPA office, with possible future affiliation, in or around New York City, transcript available upon request. Box 1402.

CPA, Society and AICPA member, eleven years experience, seeks per diem in N. Y. City area. Box 1405.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Statistical Typing, IBM typography, offset printing. Gitsham's, 480 Lexington Avenue, N. Y. 17, PLaza 5-6432.

Practice Wanted, substantial terms, know-how offered overburdened or retiring practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1385.

Office for Rent, Lindenhurst, L. I., rare opportunity for CPA, beautiful offices in shopping center, 800 car parking. Call Karp, TUrner 8-1683.

CPA Firm, N. Y. C., having gross fees in excess of $200,000 seeks practitioner for merger purposes, having substantial quality practice in predictable fees, interested primarily in spreading top level responsibilities and perpetuation of firm, replies in strict confidence. Box 1386.

Well Equipped CPA Firm will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 1387.

CPA Candidate, anxious to enlarge present practice, will purchase small accounts or bookkeeping practice from retiring or overburdened practitioner willing to accept notes, N. Y. area. Box 1388.

CPA wishes to purchase partnership interest, will consider per diem arrangement with overburdened practitioner for trial period. Box 1389.

Get A Fifth Avenue Office, without Fifth Avenue overhead, efficient, personalized, low cost mail, telephone, desk, specializing in accountant's requirements, private office space available. 516 Fifth Avenue Telephone Service at 43rd Street, MUrray Hill 2-3717.

CPA, attorney, age 34, lecturer in taxation, excellent tax and accounting background, desires to purchase practice or partnership interest, good financial terms. Box 1391.

CPA, offers residence, attached office and practice for sale in fast growing Suffolk County town, one transaction only. Box 1392.

CPAs, N. Y., 2, early 30s, extensive accounting and tax experience, desire to purchase practice of an established or retiring practitioner, substantial capital available. Box 1393.

BUSINESS OPPORTUNITIES

CPA, 35, energetic, gross fees in excess of $5,000.00, substantial free time, seeks association with overburdened or retiring practitioner. Box 1395.

CPA, 31, small practice, free time, desires to purchase accounts, cash available, will also consider proposals for an interest or association, excellent background, references. Box 1397.

Practice, individual accounts, or partnership interest, wanted by CPA, N. Y., N. J., AICPA, substantial cash available, highest professional references. Box 1400.

Office for Rent, CPA, single practitioner, has extra office, furnished or not, 1 Hanson Place, Brooklyn, all transportation and LIRR. MAin 2-2946.

CPA, working alone, would like to get in touch with other accountants similarly engaged, to explore possibilities of forming partnership for coverage of accounts and sharing expenses, Queens or Nassau residents preferred. Box 1403.

CPA, desires to purchase practice, New York City area, honor graduate, excellent tax and accounting background, specializes in highest type professional service to small and medium size accounts, excellent financial terms, replies held strictly confidential. Box 1404.

CPA, desires office, preferably in midtown Manhattan. Box 1406.

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The President's Page

Thinking Back

The realization that this is the last President's Page we shall be privileged to write brings to mind a host of pleasant recollections. It seems that it was only yesterday that with many misgivings and much doubt as to our ability to do so, we promised to try to continue the good works of Arthur Foye and his predecessors. It seems that it was only yesterday that we were choosing committee chairmen and committee members and it is with a warm feeling that we recall their acceptances and the sincerity with which they offered to work with us. Vividly we recall the Annual Conference at Saranac, the excellent technical program, the social activities and the wonderful fellowship. We knew then that the year ahead would be a good one.

The end of summer marked the start of our visits to the chapters. Seven strong we went and each visit seemed more stimulating than the last. Each chapter, in turn, through its wonderful reception assured us of its cooperation. We had no doubts as to the support of the membership.

As we think back we recall the many, many meetings we have attended during the year. There were the technical meetings which we attended with pleasure and profit; there were the general meetings with their excellent programs; there were meetings of and with other organizations; there were challenging meetings of the Board and the Executive Committee; there were meetings with members of the staff and with committee chairmen. There were innumerable conferences with our indefatigable Executive Secretary, Harry Howe. So much was accomplished.

But meetings were only part of our program. There was the Society's mail to read each day and the growing awareness derived from it of the extent and magnitude of the Society's interests and activities—and the reemphasis of what we already knew, that the Society has an exceedingly skillful staff administering it. And we recall with pleasure too, the numerous telephone conversations with chairmen, with members, with staff and with friends—every one of them interesting and constructive.

Very much in our mind as we write this Page is the Society's legislative effort. We recall its beginnings in our talks to the chapters, the many meetings and conferences which followed and the crystallization thereof in the bill introduced in the Legislature. We will always remember the trips and phone calls and further conferences; the hopes, the doubts and fingers crossed. Then success in the Senate. Failure at first in the Assembly followed by a favorable vote. And lastly our vigorous campaign to convince Governor Harriman that the bill should be signed in the public interest. We shall never forget the unfaltering support of the membership whose visits with legislators and whose letters were of inestimable value.

And lastly there comes to mind the President's Pages which preceded this. How difficult it was to get them started, how often we had to plead with Ben Newman for more time, how concerned we were as to the finished products but how pleased to have still another medium of communication with our members.

They are all wonderful memories, these and many more. It has been a most stimulating and rewarding year. To the many who helped make it so, our sincerest thanks.

LEONARD PRICE,
President

The Banker and Reporting Standards

By Arthur L. Nash

Bankers should have a clear understanding of auditing and reporting standards if they are properly to interpret audit reports. The CPA has an equal obligation to state clearly the degree of responsibility he assumes when rendering his report.

The history of the world is replete with incidents which need never have occurred had there been adequate understanding between the conflicting forces. Prejudices, which spring from lack of knowledge, affect our point of view and our sense of judgment. Those of us in The Robert Morris Associates and in the accounting profession who have been addressing groups and contributing to accounting literature on the subject of Banker-CPA relationship, have as our aim the stimulation of bankers and CPAs to meet and exchange ideas, leading to increased knowledge and better understanding.

There continue to be, and probably always will be complaints from bankers that some CPAs have not complied with standards of adequate disclosure in the financial statements and accompanying audit reports. On the other hand, accountants may complain that some bankers do not fully understand the standards of the accounting profession or the nature of the CPA's relationship with his client. It is also said that some lending officers of banks, while recognizing why an unqualified audit is important and valuable to the bank, are not as familiar with the reasons that such audits are of benefit to the client, that is, those benefits which can be derived from objective appraisal of assets, liabilities, and operations, and the other services which a competent auditor can supply.

Unless those of us in the banking fraternity who interpret audit reports and who must discuss them with clients (and, on occasions, with auditors) have a clear understanding of auditing standards and procedures, we may be at a disadvantage in properly marshalling our arguments pro and con. Certainly without such familiarity with standards and procedures, we may well leave ourselves open to contradiction if we criticize an audit report. We older executives should do our best to gain increased knowledge within the limitations of time available. However, we should see to it that our juniors are

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This article has been adapted by the author from a paper presented by him at the November 7, 1957 meeting with bankers, sponsored by our Society's Rochester Chapter.

well instructed and that our individual bank training programs accent this important aspect of credit knowledge.

On the other hand, an accountant cannot expect to be free of criticism if he fails to make clear his responsibility for the figures presented by the issuance of an unqualified opinion, a qualified opinion or a disclaimer of an opinion. It is incumbent on the accountant to be sure that his report is clear, as to the scope of his engagement, as to the terminology within the report, and as to appropriate footnotes.

Much has been accomplished over a period of the last quarter century and much remains to be accomplished. Both bankers and accountants are taking a very real interest in the advancement of our mutual aims. The banks, through the Robert Morris Associates' Committee on Cooperation with Public Accountants, have steadily attempted to present bankers' views and problems before the accounting profession. Similarly, the American Institute of Certified Public Accountants, the New York State Society of Certified Public Accountants and the various state CPA societies have been developing the accountants' point of view. One has only to read the JOURNAL OF ACCOUNTANCY and THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT to note the frequency with which articles have appeared on the subject of interpretation of audit reports, the accountants' responsibilities, and the areas in which bankers and accountants should be able to work together in the best interests of their mutual clients.

Disclosing the Degree of Responsibility Assumed

On occasion a complaint may be expressed by bankers that the auditor failed to clearly state his position with respect to the work he has performed. He leaves much to the imagination of the analyst through inadequate terminology and insufficient footnotes. Such critical comment usually arises where the engagement has been restricted and the auditor fails to make clear his position with respect to the figures. In the case of the following report, for example, what is the position of this auditor? The report is on the auditor's letterhead and the letter of transmittal in substance reads as follows:

> I have audited your books and records for the period .... and submit the following:—Balance Sheet and Statement of Profit and Loss.
>
> .... Statement is based on submitted estimated inventory of merchandise ....
>
> Cash on hand and in banks and bank loans were verified directly with depositories.
>
> Accounts receivable and accounts payable were not directly verified . . . etc.
>
> Respectfully submitted,
>
> ....
>
> (Signed)

The auditor is a member of The New York State Society of Certified Public Accountants and the American Institute of Certified Public Accountants. The auditor's name as a CPA is signed to the report or so-called "certificate" so that, obviously, he accepts some responsibility—but how much? What does he mean when he says, "I have *audited* the books."? I looked up the word audit in the dictionary; it is defined as "an official examination of accounts and other verification by reference to vouchers, etc." I doubt if he means this but what does he mean? He probably intends to take some responsibility, but just how much?

Although the CPA determines the scope of the examination necessary to express an unqualified opinion, the *client* determines whether an examination of such scope will be permitted. If the opinion is to be unqualified, the auditor must be unrestricted in his work. Often, however, in the interests of economy, the client may restrict the amount of work the CPA is permitted

to do. Unfortunately, on occasion, it is believed that some bankers support clients in this plea of economy without realizing that the resultant audit may not be fully satisfactory to the bank and may not be in the client's (or the bank's) long-term best interest. Far better, it seems to me, would it be for the banker to discuss with the clients *and* the accountants the minimum requirements of the bank and then allow them to work out the scope of the examination at the least expense commensurate with the character of the engagement.

Some of us in banking may expect to receive details on an audit which are not normally included except in a "long-form" report. Although auditors quite frequently make up a long-form report, this usually goes to management and, unless requested, is not furnished to the bank.

It should be remembered that the only important difference between the short-form and long-form report is that the latter includes more details, schedules and statistics than may be in the short-form. The standards followed, the procedures applied and the opinions expressed are the same for both forms of reports. The banker should understand that certain of the statistical data and schedules might not lend themselves to detailed audit check and the auditors position with respect to the figures should be clear.

A Case Study

May I draw from one of our files and present, in diary form, an illustration of some problems which bankers have with financial data. The example involves education—both for client and auditor—patience, understanding, frustration, and, we hope, success in the future. The text material following the diary dates represent excerpts from memoranda in our files pertaining to this case.

In February, 1953 we took on a modest-sized account engaged as commodity brokers. When the account was opened it was not expected to involve a borrowing relationship but it shortly developed that certain special accommodation was desired in line with changing conditions in the business, i.e., the need to engage in some business as a principal in order to hold some of their more desirable brokerage outlets. We were requested to open letters of credit to finance certain imports. As this was an extension of credit, we asked for a financial statement. The first statement that we received as of December 31, 1952 was unaudited. We discovered subsequently that the company used an auditor for the preparation of the partners' tax returns and, therefore, requested an audit as at December 31, 1953.

March, 1954. The report of December 31, 1953 was received with the following "certificate."

> As a result of our examination of your books and records, we have prepared and are submitting herewith, the following:
>
> Balance Sheet as of December 31, 1953
>
> Statement of Income, Profit and Loss for year then ended. We did not at this time make any external verification of any of the Assets and Liabilities. . . . We trust that the above exhibits are otherwise self-explanatory.
>
> Respectfully submitted,

April, 1954: Credit memo to Credit Committee.

Relating to December 31, 1953 statement, figures submitted were prepared by a CPA and his work was limited to an examination of the company's books and records with no external verification of any of the assets and liabilities and the auditor offers no opinion respecting the statements. Attention is directed to the fact that the balance sheet reflects no liability for direct bank debt although our records show out-

standings at statement date of $72,000 for acceptances issued December 28th. In setting up the balance sheet on our records, we have made adjustment in our analysis to reflect bank debt of $72,000 with the contra inventory in transit. This should be discussed with customer and auditor.

April, 1954. Called to the company's attention the failure on the part of the accountants to reflect acceptance liability and offsetting inventory item on company's year-end fiscal statement. The CPA was in the company's offices and I dropped in to see him and Mr. X, the principal. The accountant is a CPA although not personally a member of the New York State Society. His two partners, however, are members of the State Society. Asked CPA how it happened that the statement did not disclose acceptance liability and inventory. He said reason was that he did not verify assets or liabilities. Asked how the company's records failed to reflect such liabilities. He said it was probably because they have always set their records up as brokers on a cash basis and, therefore, as this was a new type of operation, the books had not been properly set up. Explained the necessity of having company properly record such liabilities and requested that he arrange to have appropriate records set up for such purposes. Suggested to client and CPA that they consider the question of preparing an audit which would have an unqualified certificate. CPA said that this would require more work than he had been in the practice of giving to the account and that it might cost more money. Explained to X, the owner, the desirability of having an independent check on assets and liabilities of the company and recommended an unrestricted audit.

April, 1955. Spoke to X, owner, reminding him that we have not yet received the company's annual audit for December 31, 1954. X said report was, as yet, not completed inasmuch as company's auditor was following through on certain suggestions made by me. Said that as soon as report was completed, we would receive a copy.

May, 1955. December 31, 1954 report received and following is Credit Department memorandum to Credit Committee: "Figures submitted for December 31, 1954 were prepared by an auditor. Scope is limited to an examination of the company's books without outside verification. No opinion offered with respect to statements. Activities of company as a principal and obligations due to bank, however, are now reflected in balance sheet, together with offsetting inventory details."

October, 1955. Discussed with X (owner) question of a satisfactory audit report to be submitted annually. X is not familiar with auditing practice or terminology and thought he was giving us an adequate audit. Reviewed this question and pointed out to him again the advantages of a satisfactory audit report and an unqualified opinion by the auditor. Explained that it might cost slightly more than the present examination but he raised no objections. In order that X may clearly indicate to this auditor what we want, wrote him a letter along these lines and enclosed copy of the Robert Morris Associates' booklet, "Financial Statements for Bank Credit Purposes."

April, 1956. Audit report of December 31, 1955 received. Auditor's certificate reads:

> As result of examination of books and records, we have prepared and are submitting herewith the following exhibits:
>
> Balance Sheet
> Statement of Income, Profit and Loss
>
> In the course of examination, the following verifications were made:

Cash in banks (direct communication with banks)
Cash on hand (actual count)
Accounts Receivable (direct communication, confirmations received on each)
Merchandise inventory (inventory is afloat but original bills of lading, invoices, etc. satisfactory evidence)
Accounts Payable (communication with creditors, confirmation received etc., etc.)
We trust that the annexed exhibits are otherwise self-explanatory.

Respectfully submitted,

May, 1956. Credit Department report to Credit Committee: "Figures prepared by auditor and for first time, as result of our suggestion, outside verification was made of all items. However, auditor expressed no opinion regarding the statements."

July, 1956. Again called attention of Mr. X (owner) to fact that auditor had not expressed opinion although it was obvious that figures were substantially verified.

April 10, 1957. December 31, 1956 audit received. Substantially follows the pattern of 1955 report in that all items were separately and properly verified including accounts payable, etc., but again no opinion was expressed.

May 24, 1957. Review of the December 31, 1956 audit noted that the auditors neither expressed an unqualified, qualified or disclaimer of an opinion with respect to the financial statements taken as a whole, leaving a question as to the degree of reliance which could be placed on the audit. This is in violation of the principles of the AICPA and appears particularly curious in this situation as the auditor had apparently, by confirmation and otherwise, carried out all of the procedures which would be necessary to render an unqualified opinion.

With this background, called X, the owner, who later put me in touch with the CPA. Auditor seemed unaware of the existence of *Bulletin 23* and pointed out that in his opinion, the long-form of audit report such as he had provided was far more meaningful than a "rubber stamp opinion." However, he has no hesitation in giving an unqualified opinion with respect to the figures and indicated that he would do so for our benefit on future statements. He mentioned in passing that he has had trouble with other bankers in the past on this subject.

Some Lessons Drawn

That's where it now stands, but you may well ask why we bothered to play along with this situation. I too sometimes wonder. In fact, at one point, I was so exasperated that I recommended a change in auditors. However, our client is a man of the highest moral caliber. He has used this CPA for many years and did not want to change. We could have insisted but here are some reasons why we didn't.

1. We are the only bank with whom the client deals.

2. Under letter of credit financing our trust receipt lien gives us quite strong protection.

3. The commodity has ready saleability and it is sold "to arrive."

4. The moral risk is excellent.

5. And last, but not least, the balances on deposit average in six figures. In fact they regularly exceed the total debt to us.

Hence, discretion being the better part of valor, and not wishing to take the risk of antagonizing a client by arbitrarily insisting on an adequate audit early in the relationship, we decided to try to educate both the CPA and the client.

Examples of Adequate Reporting

Meticulous reporting increases confidence. In another case, the auditor was making an audit of a commodity jobber as of December 31, 1954. During his examination, he learned that the borrower, after the statement date, engaged in some new commitments, resulting in a long position. At the end of January 1955, prices of the particular commodity took a decided drop as a result of which this position showed a substantial loss. The auditor, following the dictates of Statement on Auditing Procedure No. 25, felt that this should be disclosed and he did so in his certificate by stating:

> In accordance with American Institute of Accountants' Bulletin No. 25 issued in October, 1954, relating to events subsequent to date of financial statements, certain contracts entered into after January 1, 1955, and liquidated prior to the completion of this examination, resulted in substantial losses . . .

We subsequently learned that losses totaled 30 per cent of capital!

Another example of what can be considered excellent reporting involves the close adherence to the principle of "providing for all losses but never anticipating profits." In this case, because of delays in receipt of audit reports, we obtain advance company figures. As of December 31, 1955, the company reported a profit of $46,000. When the audit report came in, it reflected a loss of $200,000. Quite a difference! The explanation lies in the fact that the company failed to take into consideration an unliquidated loss of $246,000 on its open commodity position which was not compensated for by an unrealized gain in inventories. While this auditor followed the standards of the profession explicitly, I understand there are many situations where the client objects strenuously to such disclosure on the principle that the loss had not occurred up to the statement date and, hence, should not be reported.

Communication Between Banker and CPA

Why wait for a questionable report before becoming acquainted with a CPA? Sometimes making a friend while the going is good makes it possible to straighten a situation out when the reverse is true. I had occasion recently to compliment an auditor on what I considered a particularly good job. He not only was very clear in his certificate as to his position with respect to the figures, but he included many facts which were helpful in understanding the report. For example, he noted the year Lifo was adopted, the differential between Lifo and Fifo valuation of inventory, his approval of Lifo, footnotes on principles of consolidation (in which he accepted two audits of other CPAs), details of security on bank loans, date of last tax clearance, explanation of losses on unliquidated contracts and reserves therefor, and details of contingent liabilities.

Despite his fine job I was able to call attention to one small matter which he appreciated. He had accepted "certified audits" of other CPAs and so stated. However, I believe a certified audit does not necessarily imply an unqualified opinion. Semantics, yes, but he saw the point.

What I want to stress is that we got along famously; in fact, I was so impressed with his manner that I have placed his name on file for recommendation and I told him so. Later at my request he furnished me, for confidential reference purposes, a list of all his other clients! I'm sure that as far as this CPA is concerned we will have top jobs in the future.

Another situation involved a qualification which I did not feel was fair

to the client. In this instance the auditor says:

A substantial amount of merchandise is purchased from vendors in foreign countries. Due to the length of time required for such merchandise and related documents to arrive in this country, it is deemed impracticable to delay closing the Company's books until their arrival. Consequently, an undetermined amount of merchandise is in transit, which may be substantial, and the liability therefore has not been included in the accompanying financial statements.

He then qualifies his opinion. The fact is that the auditor's report was written three months after the statement date and he included among his footnotes, contingent liabilities as to purchase contracts. It seemed to me that within the three-month interval most, if not all, items in transit on the statement date would have been received; certainly the documents would be here, if the steamer was not. Furthermore, we have a very large number of importers among our clients, and no other auditor makes any similar qualification. Hence, I have discussed this with the auditor, on a friendly basis, and learned something about him and have persuaded him to review the facts carefully. What is more important, for the first time he realized how a reader interpreted his comments. Here, we now are on a common ground and, I hope, have made another friend.

The Natural Business Year

Banks are interested in, and the Robert Morris Associates as well as the accounting profession are supporting, the idea of the natural business year. It is recognized that the natural business year has certain very real advantages. For the client, the balance sheet would show the position at a period of theoretical lowest inventories and highest liquidity. Although I am not a tax expert, I understand that there are also certain advantages in that area. From the banks' view, we would probably get figures sooner after the fiscal date than is now the case. We would receive statements of borrowers spread more evenly throughout the year (rather than the bulk between February and May) and hence we would be able to put more time and thought on review. Also, comparisons of trends would be more significant. However, banks would undoubtedly require, in many cases, a six-month report reflecting the position of the company at the peak period. Such figures, however, would not necessarily have to be audited. For the accountants, the answer is obvious. They would be able to give prompter service to the client. There would be a more even distribution of work load over the year, and, I presume, the partners of the accounting firms could give greater personalized attention to more of their clients. Added to this, of course, is the availability of other CPA services which could be expanded with a more even work load.

Working Together

By working together and by having an appreciation of the problems and needs of each other, the bankers and the accountants can do much to improve the tools of management for our mutual clients. Among the valuable aids are budgets, forecasts, determination of natural business year, improvement of internal controls and so on. We as bankers need to know about these things. I do not mean to imply that we should sell these services, but as anyone of them would simplify our task and benefit our clients we should be prepared to back up the auditor and recommend their adoption. Bankers and accountants are both working actively toward the same end—better reporting, wiser counseling, and a sounder business for our clients. It is a long road but we are well on the way toward eliminating detours and hazards.

Second and Concluding Part

Accounting Principles and Procedures of Philanthropic Institutions

By LOUIS ENGLANDER, C.P.A.

Functional Classification of Expenses—Content of Categories

The social service objectives of an institution are translated into a program of activities or projects beneficial to the public. Each year the budget contains a list of such projects. All costs in connection with these projects, for which funds have been requested, should be included in the category, Social Service Program. Both direct and allocated costs should be included. By examination of the individual expenditures, the project which should be charged for a direct cost should be determinable. The indirect costs, such as rents, materials, etc. should be determined by the purpose for which the expenditures are made. The types of services vary with the objectives of the individual institutions. A few illustrative types taken at random, are: research, professional education, grants to other agencies; vacations for children; vocational training; individual case work; rehabilitation. Allocable costs include apportionable salaries, social security taxes, fringe benefits, travel and other expenses attributable to the individuals who work partly on some phase of social service, rent, utilities, etc.

Fund-Raising Costs

Fund-raising costs should include all expenses whose primary purpose is the solicitation of contributions. They should include publicity and promotion expenses incurred in connection with starting a campaign, all campaign costs, and all the necessary clerical and office expenses necessary to implement the campaign. Both direct and allocated expenses should be included. If several types of fund-raising effort (such as mail appeals, membership drives, special

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affairs and functions) are used, the expenses of each should be recorded separately. In connection with the special affairs and functions, only the expenses should be included. The direct costs should be deducted from the gross income.

A majority of the institutions do not consider that public education materials and services which are used in connection with a fund-raising effort, should be included in Fund-raising Costs. They allocate such costs to Public Information and Education. In a number of accounting manuals of various institutions, specific reference is made to this method of allocation. Two such manuals give the following definitions of Fund-raising Costs.

1. "Fund raising includes the expenses of the annual campaign and other fund-raising activities and the costs of publicity and promotion for the campaign. Materials and activities which are primarily educational in content and effect should be allocated to public education."

2. "Fund raising includes the expenses of the annual campaign, fees to fund-raising organizations and consultants, and all the costs of publicity and promotion for the campaign. While all the activities of the society in research, education and service may influence the willingness of the public to contribute to the support of the society, only those expenses directly incurred in fund raising should be allocated to this category. For example, publicity which is primarily educational in intent and in effect should be allocated to public education."

While not attempting to give a complete listing of all types of fund-raising costs, the following groupings indicate the major subdivisions of costs and expenses. These groupings will include all apportionments of expense account totals properly allocable to each sub-category.

1. *Publicity*—including the cost of media used in preparation for and conducting the campaign; television and radio time; newspaper, magazine and periodical space.

2. *Dinners and meetings* — for the purpose of fund raising.

3. *Campaign materials* — including costs of writing, producing or purchasing of campaign publications, products, exhibits or films; printing of pledge cards, receipt forms and other forms necessary for statistical data and record-keeping.

4. *Mailings* — including addressing, stuffing and postage.

5. *Salaries and fees*—including salaries of the fund-raising staff, and apportionment of time of others assigned to work on fund raising; fees to fund-raising organizations or consultants; social security taxes, fringe benefits and incidental expenses of fund-raising personnel.

6. *Other costs*—including clerical and bookkeeping time for receiving and acknowledging contributions, follow-up of pledges, keeping statistical records and preparing statistical reports; maintenance of contributors' mailing lists; rent and utilities.

Public Information and Education Costs

These costs should include all expenses for keeping the public informed of the services being offered; how and where these services can be obtained. In health organizations, it should in-

clude the cost of mass education of the general public with respect to a particular disease. In many institutions Public Education is one of the projects of the social service program, and as such, normally would be included in the Social Service category. However, nontechnical information, whose appeal is directed to the general lay public, usually is included in the category of Public Information and Education.

The major costs and expenses of Public Information and Education are:

1. *Publications*—writing, publishing and distributing educational materials, including television and radio scripts and announcements, pamphlets, articles, books.

2. *Instruction*—planning and presenting programs, lectures, classes, courses to the general public; training of personnel to participate in instruction.

3. *Information*—preparation, printing and distribution of materials concerning the nature and objectives of the institution; how and where the general public may avail itself of the services offered. Cost of a central information bureau open to the general public.

4. *Materials*—cost of all materials and supplies applicable to any information or education project.

5. *Salaries of participating employees*—either entire or apportioned, social security taxes, fringe benefits, and incidental expenses of these employees.

6. *Other costs*—including a portion of rent and utilities and other sundry expenses, whose purpose wholly or partially is informational and educational.

Administration Costs

Administration costs are those which deal with planning and directing institutional policies and finances. They should include the expenses of boards of directors who set policies, prepare and approve budgets; the expenses of the executive directors who carry out and interpret the policies to the staff, to other institutions, and to the public. They should also include the costs of financial management and control. Some examples are:

1. *Board of directors*—costs of meetings, travel.

2. *Overall direction*—executive director's salary, fringe benefits, travel and sundry expenses.

3. *Expense of assistants*—including secretary.

4. *Financial*—bookkeeping and accounting; legal fees; personnel management; purchasing; any other related costs.

It must be remembered that part of these costs may be incurred directly for one of the other categories, and will be so allocated. The costs remaining in the category of administration will be those not directly applicable to any other function.

Payments to Affiliated Organizations

This category applies to fund-raising agencies, and to the chapters, divisions, or branches of national institutions. The payments made by fund-raising agencies to the participating members of the agency should be included in this category. These payments represent the net cash available after all expenses of the fund-raising agency have been deducted.

Chapters of national institutions remit a portion of their contributed income to the national body. The amounts remitted are either on a percentage basis or on a budget basis, as agreed upon

between the two. Certain types of income may be excluded from the divisible amount. Contributions received by the national body for the account of a chapter are credited to the branch; such amounts are included in the contributed income of the chapter. Where the chapter remits a percentage, the total contributed income is considered as the base for the apportionment. On the books of the chapter, this category should include all payments (either in cash or through credits) to the national institution.

Chapter Expansion Costs

National institutions, in attempting to increase the scope of their activities and to render service to more communities, either expand existing chapters or create new chapters. On the books of the national body, all costs expended for these purposes should be charged to this category.

It is recognized that the chapters furnish opportunities to extend the social service program to new communities, or to a larger public in communities already being serviced. There are corollary advantages in the process. New sources of contributions are opened. It is possible that some of the costs of chapter expansion might be chargeable to fund raising, but no workable formula has been suggested for such an apportionment. If the purpose of the expenditures truly is for greater opportunities for social service, it would not appear necessary to make such an allocation. Some institutions do not take the required cash from current contributions, but use earmarked funds to meet this objective.

Central Services Costs

This category is used primarily by fund-raising agencies and by national institutions. To it are charged all costs of services performed for the benefit of participating institutions and chapters. In fund-raising agencies, all costs are apportioned between those applicable to the agency itself and those applicable to its participating members. In national institutions, special services such as central purchasing, recordkeeping, preparation of fund-raising and public information materials may be performed.

Capital Expenditures

This category is used by institutions which do not capitalize their expenditures for fixed assets. It should include all expenditures for furniture, fixtures and equipment.

Methods of Allocating Expenses

Because expense accounts indicate merely the nature of the expense, it is necessary to analyze them further to indicate their purpose. Each nominal account may contain expenditures for various categories of expense. The account "Salaries" indicates the payment for services performed by employees, but not the purposes of the services. It is necessary and in accord with sound accounting principles to allocate the salaries into categories, showing the purpose of the expense. Although each institution can determine which method of allocation best suits each type of expense, a few general suggestions may be made which should be applicable to all institutions. For this purpose, expenses may be divided into three groups—(a) those in which employees' time spent is the determining factor (such as salaries); (b) those which may be allocated on a predetermined percentage basis (such as rent); and (c) those whose purpose must be examined when

the expenditure is made to determine its allocation (such as materials and supplies). In groups (a) and (c), allocations should be made concurrently with the expenditures. Actual time and expense records of employees should be maintained. Allocations should not be made at the end of a period, on an estimated basis. In group (b), the basis of the determination of the percentage should be noted. The allocation may be made periodically.

Expense allocations may be made on the basis of:

1. Time spent by employees, as determined by time sheets.

2. Space used.

3. Activity or category benefited.

4. Nature and content of materials.

5. Immediate purpose of the expenditure.

There are many employees who perform more than one function, whose time must be allocated among the categories. While the best method of determining the allocation is through daily time sheets, many institutions believe this is too arduous and expensive a method. They keep these records for a portion of the year (such as a month or a quarter), and determine therefrom a percentage to be used for the year as a whole. Of course, where an employee works wholly within one function or category (fund raising, social service program) no allocation is required.

Occupancy expenses should be allocated on the basis of space used. The floor space allotted to and used for each category should be determined, and a percentage of the total space should be calculated. This percentage should be applied to all occupancy costs to determine the final apportionment. There are some expenditures (such as stationery and office supplies) made for the joint advantage of all the categories. These should be allocated on the basis of the activity of the category benefited. Since at the time of purchase it would be difficult to determine the amounts to be allocated, a percentage basis may be used. The percentage should be determined by an analysis of the actual distribution over a period of time (as a minimum, a two- or three-month period). Printed materials, publications, etc., are prepared or purchased for various purposes. The nature or content of such materials should determine their allocation. Where none of the methods clearly indicate the categories to be charged, the immediate purpose of the expenditure should determine its allocation.

Financial Reports

In the preparation of financial reports, the goal of accounting for philanthropic institutions must be borne in mind—that the reports are the financial presentation of management's stewardship of unrestricted funds and of its fiduciary obligations with respect to restricted funds. Reports should be prepared on the basis of this dual relationship, as if the institution had two individual entities. There should be two sets of financial reports, one for unrestricted funds, the other for restricted funds. Each of the two groups may be subdivided. The unrestricted funds may be segregated into current operating funds and earmarked funds reserved for special current or deferred purposes. Restricted funds may be segregated in accordance with restrictions. Each of the subdivisions may be reported as if it were a separate entity. The reports are prepared and issued for the benefit of management itself, for the contributors, for governmental agencies, and for other regulatory bodies. They should be prepared in as simple a manner as is consistent with the full disclosure of all material facts, since they will be ex-

amined not only by individuals trained to read and interpret the statements, but by the general public which is not so trained.

The Balance Sheet

The balance sheet should be presented not as a single unit of assets and liabilities, but as a group of individual statements—one for each fund. In effect, there should be as many balance sheets as there are funds, each independent of the others. There are a number of methods of presentation—(a) an individual balance sheet for each fund, presented in separate exhibits; (b) one exhibit, showing first the combined balance sheet of all unrestricted funds, followed by the combined balance sheet of restricted funds, the details of the individual funds of each group to be presented in separate supporting schedules; (c) one exhibit for all funds, showing the balance sheet of each individual fund, one following another; (d) one exhibit showing the balance sheet of each unrestricted fund, one following another, and a second exhibit showing the statement of changes in net assets of restricted funds.

If income is reported on a cash basis, the amount of pledges receivable should be disclosed. This may be done as a footnote on the balance sheet, disclosing the gross amount, and the anticipated collections thereon, or in the balance sheet itself, showing the gross amount less a 100 per cent reserve.

If buildings are set up at a nominal cost, the purchase price of the buildings and the fair market value of donated buildings should be shown. In lieu of this, or in addition, it may be desirable to show the estimated current market value.

The Operating Statement

The operating statement may be either a statement of cash receipts and disbursements, or a statement of income and expenses. In either case both income and expenses should be reported by funds and by categories.

Income other than contributed income and endowment income should be related to the costs necessary to obtain it. Membership dues should be related to membership costs and expenses; the costs and expenses of sales or services rendered should be segregated and applied against earned income from sales and services.

Unlike the balance sheet treatment, where each subdivision of unrestricted and earmarked funds may be considered as a separate unit, income and expenses should be reported in only two groups —unrestricted funds and restricted funds. The income and expenses applicable to each subdivision of the groups should be reported, either in columnar form in the proper exhibit or as separate schedules of the exhibits.

Reporting expenses by expense classifications, through nominal accounts only, does not present full disclosure of the facts. The functions or purpose of the expenditure should be reported by means of functional classifications or categories. Since this type of classification requires allocation and apportionment of expenses, the auditor should include a statement in his report to the effect that the bases of allocation have been examined and approved by him.

At least two categories of expenditures should be included in the report— expenditures for the social service program, and expenditures required to implement the program. Each group may be subdivided as required by the reporting institution.

The operating statement for restricted funds may be omitted if it is replaced by a statement of changes in the net assets of these funds.

Transfers between unrestricted and restricted funds result in income for one and expense for the other. Transfers between any two unrestricted funds do not. If a restricted fund whose income is available for general purposes transfers cash to an operating fund, the amount transferred is an expense of the restricted fund and is income for the operating fund. If the operating fund transfers cash to an earmarked endowment fund or to a temporary special purpose fund, (all of which are unrestricted funds) neither the income nor the expenses of unrestricted funds as a group is involved.

Illustrative Financial Reports

In the following statements, only the generic titles will be used. "Cash" will represent all the individual items usually appearing on balance sheets, such as cash on hand, cash in individual banks, cash in savings accounts, etc. The accounts will not be listed by groups, such as current, fixed, etc.

The following statements are presented:

(a) Balance Sheet.

(b) Statement of Changes in Balances of Unrestricted Funds.

(c) Statement of Changes in Balances of Restricted Funds.

(d) Statement of Income and Expenses.

(e) Statement of Expenses Allocated into Categories.

Figure II

BALANCE SHEET—DECEMBER 31, 19—

Assets			Liabilities and Fund Balances		
Unrestricted Funds					
Operating Fund:					
Cash	$x		Accounts payable	$x	
Investments	x		Accrued expenses	x	
Receivables	x		Operating Fund balance (Note)	x	
	—			—	
		$x			$x
		=			=
Endowment Fund:					
Cash	$x		Endowment Fund balance	$x	
Investments	x				
	—			—	
		$x			$x
		=			=
Restricted Funds					
Research Fund:					
Cash	$x		Unpaid appropriations	$x	
Investments	x		Research Fund balance	x	
	—			—	
		$x			$x
		=			=
Building Fund:					
Land and building, at nominal value (cost $)	$x		Building Fund balance	$x	
	—			—	
		$x			$x
		=			=

Note: Pledges receivable in the amount of $.......... are not included.

Figure III

STATEMENT OF CHANGES IN BALANCES OF UNRESTRICTED FUNDS

Year Ended December 31, 19—

OPERATING FUND		
Balance of Fund—January 1, 19—		$x
Additions		
(Specify)	$x	
Income for year (Page)...	x	
		x
		$x
Deductions		
(Specify)	$x	
Expenses for year (Page)...	x	
		x
Balance—December 31, 19— (Page)		$x

Note: Continue with similar statement for each unrestricted fund.

Figure IV

STATEMENT OF CHANGES IN BALANCES OF RESTRICTED FUNDS

Year Ended December 31, 19—

RESEARCH FUND:			
Balance of Fund—January 1, 19			$x
Consisting of			
Cash	$x		
Investments	x		
	$x		
Income			
Contributions		$x	
Gain on sales of securities		x	
			x
			$x
Expenses			
Awards for research		$x	
Custodial fees		x	
			x
Balance of Research Fund—December 31, 19—			$x
Consisting of			
Cash	$x		
Investments	x		
	$x		
Less unpaid appropriations	x		
	$x		

Figure V

STATEMENT OF INCOME AND EXPENSES

Year Ended December 31, 19—

	Total	Operating Fund	Endowment Fund
INCOME:			
Contributed income ...	$x	$x	$x
Membership dues	x	x	
Endowment income ...	x	x	x
Earned income	x	x	
	$x	$x	$x
Interfund transfers		x	(x)
TOTAL INCOME	$x	$x	$x
EXPENSES:			
Fund raising	$x	$x	
Public information and education	x	x	
Administration	x	x	x
Chapter expansion	x	x	
Capital expenditures ..	x	x	
Social service program	x	x	
TOTAL EXPENSES ..	$x	$x	$x
EXCESS OF INCOME	$x	$x	$x

NOTES:

1. If earned income is material, separate schedules should be prepared showing gross income, costs and expenses.
2. Contributed income should be classified in accordance with form presented on page 284 (April 1958 issue).
3. Supporting schedules of expenses are shown on page 340.

Suggested Accounting Principles for Philanthropic Institutions

This article has attempted to point out differences in accounting procedures of business enterprises and philanthropic institutions. From a review of the subject and an analysis of the differences, it is possible to formulate a statement of accounting principles applicable to philanthropic institutions. These suggested principles will be presented in three groups—conventions, standards of recording, and doctrines of reporting.

Conventions

1. *Non-profit Viewpoint.* Philanthropic institutions are organized for social service, not for profit. Therefore, the accounting principles and procedures applicable to the determination of business net income do not necessarily apply.

2. *Dual Entity Concept.* As in business enterprises organized for profit, each individual agency is deemed to be a separate and distinct entity. However, in philanthropic institutions, each agency may have a dual entity—one which receives and accounts for the unrestricted

Figure VI

STATEMENT OF EXPENSES ALLOCATED INTO CATEGORIES

Year Ended December 31, 195——

Account	Total	Fund Raising	Public Information and Education	Administration	Chapter Expansion	Capital Expenditures	Social Service Program
1. Salaries							
2. F.I.C.A. and fringe benefits							
3. Rent and utilities							
4. Building repairs and maintenance							
5. Travel, auto expense, carfare							
6. Telephone and telegraph							
7. Meetings, conferences, dinners							
8. Professional fees							
9. Office supplies and expenses							
10. Rental and service of equipment							
11. Insurance							
12. Printing and lettershop, including distribution expenses							
13. Publications purchased							
14. Development of materials for publications							
15. Publicity and promotion							
16. Furniture and fixtures							
17. Chapter assistance and expansion							
18. Special fund-raising events							
TOTALS							

contributions and sundry other income; the other, which acts as custodian for restricted contributions, to be used and accounted for as the donors have prescribed.

3. *Annual Accounting Period.* The life of any enterprise ordinarily is planned to extend over a period of years. In order to facilitate recording and reporting, the financial data are recapitulated in terms of annual fiscal periods. In philanthropic institutions, a further reason exists for this procedure. Their major source of income is contributions, received in the main as a result of annual fund-raising efforts. There is no assurance that there will be a repetition or continuity of contributions, without additional fund-raising efforts. The annual accounting period is not only convenient, but also logical.

4. *Responsibility for Adherence to Budget.* To justify requests for contributions, the public must be informed of the aims of an institution, the specific projects contemplated to fulfill the aims, and the anticipated costs. For this reason, budgets should be prepared and presented to the public as part of the appeal. The budgets constitute an implied promise as to the manner in which contributions will be utilized.

5. *Special Nature of Accounting Goal.* The goal of accounting should be the recording and reporting of financial transactions in a manner which will best account for the stewardship of unrestricted funds and the trusteeship of restricted funds.

Standards of Recording

1. *Recordkeeping on Fund Accounting Basis.* The books should be set up and reports made on the basis of funds, each fund to be treated as if it were a separate entity. If unrestricted funds are thereafter earmarked by the directors for special purposes, each such fund should be treated as a separate entity.

Accounts should be set up not only by natural classification, in nominal accounts, but also should be subdivided by functional classifications, into categories.

2. *Matching of Revenues and Expenditures.* In business enterprises operating on the accrual basis, revenues must be related to applicable costs in the determination of net income. All costs, whether or not paid for, must be matched against all revenue, received or receivable. Costs are ordinarily incurred with the primary expectation that they will produce revenue. In philanthropic institutions this principle is applicable only to earned income, where corresponding costs and expenses should be related.

In philanthropic institutions, contributed and other income must first be released or raised in order to provide the means of meeting all expenditures, whether for current operational costs or for capital expenditures. Hence the matching process consists of relating the contributed and other income to all expenditures made in the same fiscal period, whether or not the expenditures have been wholly consumed therein.

Income and expenses may be recorded either on a cash, accrual, or a modified accrual basis, as long as there is full disclosure of material facts. It should be noted that a majority of institutions use the modified accrual basis of recording.

3. *Expense Proration Principle.* Normally, expenditures should not be prorated by accounting periods, but should be recorded as expense in the year they are incurred. This includes payments for capital expenditures — buildings, furniture and fixtures and automotive

equipment. It includes expenditures for items whose useful life extends beyond the current accounting period—insurance premiums, publications distributed without charge, etc.

There may be two exceptions to this procedure

a. In the case of expenditures related to earned income from sales or services, as noted above, prorations should be made unless they are immaterial in amount.

b. In some instances, this procedure may have the effect of invalidating comparisons of operations between years. Although variations of expenditures for a particular item of expense may readily be explained, if proration is used as a better method of comparison, it should be considered acceptable.

The cost of buildings should not be amortized by periodic depreciation charges in the operating statement of the General Fund. It should be set up, in a special fund, either at cost or at a nominal value. If the building is set up at cost, depreciation may be charged against the special fund, so that a record of the current amortized value of the historic cost is available. It must again be emphasized that depreciation should not be charged as an operating expense.

4. *Expense Allocation Principle.* Expenses should be allocated among functional classifications or categories, to show their purpose as well as their nature. Those methods of allocation should be applied which best fit the various types of expenditure. The purpose for which the expenditure was made should serve as a guide for its classification.

Doctrines of Reporting

1. *Full Disclosure.* Reports should reveal all material financial data in as simple a manner as possible. In furtherance of this requirement, the reports of unrestricted and restricted funds should be presented separately. Income and expenses of each fund should be segregated into functional categories.

2. *Budget and Operating Statement Comparison.* Actual results of operations should be compared with budgeted figures. In this way the public is afforded the opportunity of judging how well the implied promises of the budget had been fulfilled.

3. *Bases of Expense Allocations.* A statement concerning the methods of allocation should be included as part of the financial report. Although a detailed report of the bases used need not be included, those who read the report should be assured by the auditor that the methods employed were investigated and found to be satisfactory.

4. *Consistency.* Reports should be prepared from accounting records maintained on a basis consistent with that of prior years. Any material variation in principles applied should be noted in the report.

5. *Conservatism.* Fixed assets may be reported at a nominal value, which is less than the cost. In business enterprises, this procedure is unacceptable because

a. It reduces profits improperly, while

b. It creates a hidden reserve, thereby understating the net worth.

There is justification for the doctrine as applied to philanthropic institutions. No profits are involved; hence, there is no improper reduction thereof. The hidden reserve created applies only to the plant or building fund, which was created through contributed income. The expenditure of that income will

have been reported in the year it was received, thereby fulfilling the obligation of the institution to account for income received. The building may be regarded as a necessary tool for the implementation of program over subsequent years. While it is true that there is an intrinsic value not recorded among the assets, thereby creating a hidden reserve, that reserve normally cannot be used for the current purposes of the institution. If desired for the purpose of full disclosure, the original cost of the assets recorded at a nominal value may be noted in the report.

A Forward Look

The present report does not pretend to be a complete study of the accounting principles and procedures employed by all philanthropic institutions. On the other hand, it is based upon a thorough investigation of a sufficiently representative cross-section of this field. There is sufficient agreement in the major areas of recording and reporting to conclude that a statement of generally accepted accounting principles for philanthropic institutions can be formulated. Certainly there was an intense desire among the participating individuals and institutions to cooperate fully. The necessity for continued study is recognized.

The combined knowledge and experience of all public and private accountants involved in this field should be utilized in the reexamination and appraisal of the statement of acounting principles proposed herein. Those which withstand such a test of general acceptability should be incorporated into a statement of generally accepted accounting principles for philanthropic institutions. This may best be done under the sponsorship of some recognized professional accounting group working in conjunction with research agencies in the various fields of philanthropy.

There is a definite need for the creation of a uniform terminology in this field, and a refinement of the concepts applicable to the terminology established. This is of sufficient importance to warrant further study by a special committee of the group suggested previously.

Two factors give rise to the opinion that the categories of expenses in use at present may be inadequate or impractical — the changing concept of fund raising and the mass education program of many institutions. The title of the category, Fund Raising, is believed to be inadequate and misleading to describe the types of costs presently included therein. Mass education is the purpose and the program of a number of institutions, which would classify the costs as part of their social service program, not as public information and education. The problem of reclassifying and renaming of categories should be investigated.

The accounting problems of philanthropic institutions differ from those of business enterprises organized for profit. These institutions form a sufficiently large segment of enterprise activity to have warranted this study. It has been undertaken with a view to assisting in the establishment of uniform accounting principles and procedures which will make financial reporting more useful to the institutions themselves and to the general public. It is hoped that this report on the study has fulfilled these objectives.

Tax Treatment of Meals and Lodging

By Paul V. Wolfe, C.P.A.

This article presents a summary description of the tax treatment afforded the value of meals and lodging furnished to employees, and points out the extent of taxability under the Federal and New York State tax laws.

The enactment of Section 119 of the Internal Revenue Code of 1954 and the adoption of regulations thereunder, reinstated the doctrine of "convenience of the employer" in determining the taxability, for federal income tax purposes, of meals and lodging furnished to employees. However, the topic has been the source of a great deal of current confusion and uncertainty in those situations where meals, lodging or both are customarily given to employees. A great deal of this confusion stems from the fact that the application of the "convenience of the employer" rule was changed twice during the past seven years, once retroactively by the Commissioner of Internal Revenue in 1950, and the second time by the Congressional adoption of the new section of the Internal Revenue Code.

The confusion is further compounded when one considers the varying treatments accorded to meals and lodging under the income tax laws of the various states, the federal social security and unemployment tax laws and the state unemployment insurance and disability laws. This article discusses the varying treatments under many of these different tax laws where meals and lodging are required to be considered as a factor in determining tax liability.

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Federal Income Tax Treatment

Under Section 119 of the Internal Revenue Code of 1954 the value of meals is excludable from the gross income of the employee receiving the same where meals (1) are furnished on the business premises of the employer, and (2) are furnished for the employer's convenience. The value of lodging is similarly excluded under the same code section where the accommodations are furnished (1) on the employer's business premises, and (2) where the employee is required to accept such lodging as a condition of employment. If these prescribed conditions are met, both these exclusions may apply even though the employment contract between the parties indicates that the meals and/or lodging are intended as additional compensation.

A Comparison With Prior Law

Under the 1939 Code, as modified by the Commissioner of Internal Revenue retroactively in 1950 (see 1950-1 CB

15), the value of meals and lodging was required to be included in gross income of the employee receiving the same if the meals and lodging represented compensation or supplementary compensation. The "convenience" rule was to be employed administratively only in cases where the compensatory nature of these benefits was not otherwise determinable; or in other words, where the employment contract or union contract was silent with respect to the employer's obligation to furnish meals to its employees. In almost all cases where there was an employment contract (as for example where the New York Hotel Trades Council bargained for all of its members employed in New York City hotels) in which there were pay differentials set forth where the employer had the option of providing meals and a lesser cash wage, or where the employer obligated himself to furnish meals to his employees, the Internal Revenue Service required that the value of such meals be included in gross income and the appropriate amount of tax withheld thereon.

Under the new law no special problems are presented from the employer's point of view. The regulations (Reg. 1.119-1) clearly illustrate the situations where meals are to be regarded as for the employer's convenience. They state that meals furnished immediately before or immediately after the employee's tour of duty as well as meals furnished during the working day are deemed to be for the convenience of the employer, if furnished for a business purpose of the employer other than granting additional or indirect compensation. Furnishing of a meal before the tour of duty obviously encourages the employee to report in advance of his scheduled tour, and assures that he will commence work on time. Similarly, where the meal is furnished after working hours, it insures that the tour of duty will be completed in orderly fashion, and that the employee will not disrupt the functioning of the employer's business. The business purpose in each instance is clearly demonstrated.

However, where meals are furnished on an employee's day off, the value of such meals would ordinarily be includible in gross income unless the employee was required to be "on call" during this period of time.

With respect to lodging, the regulations cite the following examples.

1. A civil service employee of a state is employed at an institution and is required by his employer to be available for duty at any time. Accordingly, the employer furnishes the employee with meals and lodging at the institution. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

2. An employee of an institution is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the institution the value to the employee of the lodging furnished by the employer will be includible in the employee's gross income because his residence at the institution is not required in order for him to perform properly the duties of his employment. (Reg. Par.1.119-1.)

Ordinarily, the employer can easily decide if the prescribed tests are met. Analysis of the operative facts and circumstances will enable the employer to determine whether he has a business

purpose (other than providing indirect additional compensation to his employee) in furnishing meals and/or lodging.

Convenience-of-Employer Criterion

Under the normal employer-employee relationship, it will not be difficult to determine who is the employer and when meals and lodging are given for his convenience. But in some instances, there has been a certain amount of difficulty in determining whether the "convenience" rule had any proper application.

In the *Benaglia* case (36 BTA 838), decided in 1937, the taxpayer was employed by a corporation as manager of several of its hotels and his employment contract provided that he was to receive meals and lodging at one of the hotels in addition to his regular salary. Even though stated to be compensatory in nature, the court ruled otherwise, upon a showing that the taxpayer took his meals and lived at the hotel as part of his managerial duties rather than for his own personal convenience; thus, he was not taxable on the value of meals and lodging, since they were not to be regarded as compensatory for tax purposes. The Commissioner acquiesced. Subsequently he amended the Regulations dealing with exclusion of lodging to also exclude from taxable income the value of meals furnished for the employer's convenience.

Attention is called to the fact that if an employee is required to reimburse the employer for meals and lodging furnished in kind, the value of such meals and lodging are not excluded from the gross income of the employee. This is so even though the employee is required to live on his employer's business premises in order to properly perform the duties of his employment. Income tax regulations, Section 1.119-1 promulgated under the authority contained in the 1954 Code, provide that the exclusion from income "applies only to meals and lodging furnished in kind, without charge or cost to the employee." These principles are reflected in the decision in the recent *Boykin* case (29 TC — 88).

Where the employer is a corporation, any of its employees, even those who are officers and stockholders, can exclude the value of meals and lodging furnished for the corporate convenience. However, some interesting questions have been presented for decision where partnerships or individual proprietors were involved.

In the *Papineau* case (16 TC 130), decided January 1951 by the Tax Court, it was held that a partner who managed a hotel could exclude the value of meals and lodging from his own income, without upsetting the partnership's deduction for the cost of such meals and lodging. Thus, the Court held that the business nature of these expenses to the partnership far outweighed their personal nature to the partners.

In 1955, the Tax Court rendered the same decision in *Doak* vs. *Commissioner* (24 TC 569) on the authority of their previous decision in the *Papineau* case. The Commissioner took an appeal to the Court of Appeals for the Fourth Circuit which reversed the Tax Court, saying that the cost of meals and lodging furnished to an owner and operator of a hotel could not be deducted in computing partnership net income.

Under the *Doak* decision, it now becomes settled that the value of meals and lodging cannot be excluded from gross income in the case of proprietors or partners, since they can never be classed as employees of their own busi-

ness. The expenses attributable to such meals and lodging must be calculated and excluded from the expenses of business, thereby increasing the net income reportable in the individual's return. Further, the cost of such meals and lodging is clearly a personal expense to the partner or owner rather than an expense of operating the business, even if all the tests applicable to the "convenience of the employer" rule are satisfied. The rule fails of application because there is no separate "employer" in the legal sense of the word.

Once the propriety of the deduction is established, the tax treatment, insofar as the employer's return is concerned, remains unchanged. He gets a deduction for the cost of the employees' meals consumed, either by setting up a separate deduction for "Employees' Meals" or by including it in his cost of food sales. The value of employees' lodging will not appear in the employer's tax return, inasmuch as the theoretical rental value will have already been deducted from theoretical gross rental income in reconciling down to the actual rental income to be reported on the employer's income tax return.

It should be noted that cases arising from tax years prior to 1954 being decided currently are still governed by the 1939 Code, and if compensation was or could be spelled out from the employment contract or the intent of the parties, the value thereof had to be included in gross income, regardless of whether the meals or lodging were in fact given for the employer's convenience. (*Romer,* 28 TC 145.)

New York State Income Tax Treatment

The federal "convenience of the employer" rule has no counterpart in the employee's computation of taxable income for New York State income tax purposes. The New York State rule is set forth in regulation Article 25, as follows:

" . . . Where services are paid for with something other than money the fair market value of the thing taken in payment, at the time such payment is made, is the amount to be included as income. . . . Where board, lodging, maintenance or living quarters are furnished to employees as a part, either expressed or implied, of the contract of employment, and such emoluments have a cash value in serving to reduce the personal living expenses of the employee, the money equivalent or cash value which represents the gain or the reduction in the personal living expenses of the employee should be added to his cash compensation. However, where such remuneration constitutes purely a gratuity or voluntary payment independent of the contract of employment and *provided that no pecuniary benefit or profit* accrues to the employee therefrom, the same will not be considered as taxable income. . ."

A careful consideration of the foregoing language of the regulation indicates that there are very few, if any, instances where meals and lodging furnished to an employee are not subject to tax. It is also clearly indicated that the amount of income received by an employee by reason of his being the recipient of such emoluments is to be taken into income based upon a subjective appraisal of the amount by which his personal living expenses are reduced as a result of receiving such emoluments. This situation presents a difficult administrative problem for the employer with regard to his obligation under the law of reporting compensation paid to employees in furnishing meals and lodging to employees. In order for the employer to properly

ascertain the amount of taxable income to an employee by reason of the employee's acceptance of meals and lodging, it is really necessary for the employer to be fully acquainted with the living standard of the employee. This can be a tremendous burden on the employer in reporting to the State the taxable income received by the employee. As a practical matter in meeting this obstacle many employers have reported meals and lodgings furnished to employees at amounts based upon the valuation rates for meals and lodgings promulgated by the Industrial Commissioner for New York State unemployment insurance tax purposes.

A practical illustration of the effect of the foregoing rule could be illustrated by the following circumstances. If an employee is married and maintains a separate home but is required by reason of his employment to stay on the employer's premises for a period of time and a room is provided him for such purposes, it can be readily seen that the employee could not be taxed on any value of the room because his personal living expenses were not reduced. On the other hand, if luncheon meals were also furnished to the employee, five days a week, it would appear that the employee would be considered as having taxable income by reason of receiving such meals to the extent that his personal living expenses were reduced thereby.

Federal Social Security Aspects

Even though the employee may exclude the value of meals and lodging from gross income for federal income tax purposes, such values are considered remuneration for federal social security tax purposes. No valuation of meals, lodging or any combination of the two has ever been definitely established by the Social Security Administration. The social security regulations state that the "fair cash value" of these items is to be used in computing the amounts includible in the taxable wage base, and they have sanctioned among other methods the use of the values adopted by the various states which are required to be used for state unemployment insurance purposes. Thus, the values may range from $5 to $20 per week for full room and board and from 20¢ to 66⅔¢ for single meals, depending on the particular State.

The employer must include the appropriate value of meals and lodging and pay the entire 4½% tax thereon. He, of course, recovers approximately half this expense through employee payroll deduction of 2¼%.

Federal Unemployment Insurance

The value of meals and lodging required to be used in computing the federal unemployment tax is the same as that defined in the state unemployment insurance law for the state or states in which the employer has taxable payroll. The annual federal unemployment insurance tax return itself calls for "taxable payroll" as defined in the State Act. Attention is called to Rev. Ruling 57-471 which sets forth the present position of the government with regard to the taxability of meals for federal unemployment insurance tax purposes. Under this rule it is stated in substance that where meals are furnished to an employee by an employer engaged in the business of a hotel, restaurant, lunch counter or cafeteria, such meals furnished to employees are subject to tax, whereas meals furnished to employees of other businesses are not subject to tax. The ruling attempts to clarify the application of Ruling SST 302 issued in 1938, which dealt with a

situation where a bank furnished meals to its employees, and held that the meals so furnished were not subject to tax. The basis for the distinction between the two types of situations, as explained in Rev. Ruling 57-471, is based on the theory that "as a practical matter the value of such meals [furnished to employees in the restaurant industry] is generally regarded as part of the employees remuneration and . . . constitutes an appreciable part of the total remuneration of such employee."

While the foregoing constitutes the present position of the federal unemployment insurance tax department, it is submitted that the difference between the two classifications, one resulting in a tax on employees' meals and the other exempting said meals from a tax, is a distinction without a difference. It is this writer's opinion that the tax distinction between the two situations does not withstand critical analysis. If meals furnished to employees of a bank are considered to be non-taxable, then certainly the meals furnished to employees of hotels, restaurants, lunch counters and cafeterias should be similarly non-taxable. In the consideration of this problem, meals furnished to employees of hotels, restaurants, lunch counters and cafeterias are invariably given to the employees as a convenience to the employer so that the employees can, with convenience, carry out their employment duties. For income tax purposes the ruling is now clearly established that where meals are furnished to employees on the premises of the employer for the employer's convenience, said meals are not subject to income tax.

Waiters and others engaged in the food service industry invariably receive meals and it is essential and necessary for them to have said meals on the employer's premises in order to enable the employer to conveniently serve the public. If a waiter or chef, right in the middle of a meal or shortly before the service or preparation thereof, were to leave the employer's business premises for the purpose of securing a meal elsewhere, it can be readily seen that the employer's business would be seriously affected. Meals furnished to employees of the food service industry are never specially prepared for the employees who invariably have to take "pot luck" with regard to partaking of meals made available to them by the employer. These facts clearly lend themselves to the non-taxability of the meals furnished.

State Unemployment Insurance

All of the states require that meals and lodging furnished employees be considered in computing unemployment insurance taxes. Only two states (Missouri and Texas) have not established definite values to be included in computing taxable wages paid. All the other states have prescribed minimum values and most provide that the employer may use higher values, if such are set by agreement with the employee or employee bargaining representatives.

New York State has adopted the following schedule in valuing these benefits: Meals—25¢ per meal; Lodging —$2.50 per week or 40¢ per day.

Where an employer can show that these values, fixed by the State's Industrial Commissioner, are in excess of the true value, he will be permitted to substitute the true values.

It should be noted, in the case of meals, that they are considered as part of "taxable wages" generally, but some special situations exist where meals may be excluded from the tax base. Such a case would occur where an em-

ployer could show that free lunches, for example, were given to employees voluntarily and outside the contract of employment, and that the wage scale was not affected by the furnishing of such "free lunches."

It should be noted that "supper money" payments made to employees who work overtime and who necessarily incur the expense of an additional meal are deemed excludable from taxable wages in all 48 States for unemployment insurance purposes and are similarly treated for federal and state income tax purposes.

New York Disability Law

The New York Disability Benefits Law requires that the value of meals and lodging be included in computing the wage base subject to the disability tax law provisions. In establishing the value of meals and lodging, any values mutually agreed upon and set forth in the contract of employment or collective bargaining agreement are to be used. If there is no contract valuation, the law provides that the hourly rate differential as provided in the applicable state minimum wage be used. For example, in the restaurant industry, the current differential is 10 cents per hour. That is, a full time employee who receives two meals per day on each day worked may be paid 10 cents per hour less than the straight cash wage rate per hour where no meals are involved. Therefore, in the absence of a contract figure, ten cents per hour ($4.00 per 40 hour week) would have to be added to the cash wages paid in order to determine the wage base subject to the Disability Insurance law.

Similarly, lodging is to be valued at $2.50 per week (40 cents per day) in determining the wage base subject to the disability levy.

The hourly differential assigned in the minimum wage order varies in each industry. The differential in the hotel industry minimum wage order is currently six cents per hour for meals, but varies according to employee classification for lodging.

Internal Accounting Reports

The primary function of an accounting report should be its use as a basis for action. The collection and accurate recording of information is not a difficult process in itself, but unless the implications flowing from the facts and figures presented are clearly understood by the recipient the value of the report as an instrument of management is negatived. Weakness in presentation may be responsible for corrective action being delayed or even completely neglected. In such circumstances the report has lost its objective value. Its preparation has merely provided academic exercise for the accountant, and the time spent in compilation represents an economic waste.

An accounting report should be a basis for action, and the action must not be delayed, particularly today when trade and economic conditions are subject to rapid change, and management is continuously required to make immediate decisions. The information which is one of the bases for determination of the course of action to be taken must be readily available, now, so I stress the importance of timeliness in the preparation of internal reports for use by management.

C. R. Hicking, "Accounting in This Managerial Age,"
The Australian Accountant, February 1958

The Robinson-Patman Act and the Accountant

By JERROLD G. VAN CISE

After a discussion of the price-discrimination provisions of the Robinson-Patman Act and an analysis of the legal issues involved, the author deals with the technical accounting aspects which necessitate a close attorney-CPA working relationship.

The accountant in the discharge of his professional duties frequently comes upon disturbing indications that his client is engaging in price discrimination. On these occasions, it may not always be clear whether or to what extent he should concern himself with this discrimination in view of the legal issues raised. The objective of this article, accordingly, is to outline the legal issues raised by price discrimination and the nature of the role which the certified public accountant may play with respect thereto. First, there is presented a general explanation of the manner in which an attorney analyzes discrimination in the light of the controlling provisions of the Robinson-Patman Act. Second, there follows a detailed discussion of how the attorney requires the assistance of the accountant to deal with the cost justification phase of this Robinson-Patman analysis. Finally, there are submitted a few practical suggestions with respect to the manner in which the two professions might discharge their respective cost justification roles.

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This article is an expanded and formal adaptation of a paper presented by the author at the November 21, 1957 technical meeting sponsored by our Society's Committee on Cost Accounting and Inventory Methods.

General Analysis

Statutory Provisions

An attorney who undertakes to analyze an alleged discrimination in the light of the Robinson-Patman Act must, of course, initially study the statutory requirements of that Act.

Section 1(a) of that Act (known also as Section 2(a) of the Clayton Act) provides, in part:

"That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them * * *"[1]

Upon study of these provisions, the attorney finds that the Act in essence forbids a discrimination where the following three facts exist:

1. A discrimination in price,
2. Between purchasers of commodities of like grade and quality,
3. Where the effect may be substantially to lessen competition, tend to create a monopoly or injure competition with any person.

Sections 1(a) and (b) of the Robinson-Patman Act further contain certain provisos qualifying and to a degree nullifying the above prohibition of discrimination. Quotation of these provisos here is unnecessary. It is enough to say that the attorney, following a study of these qualifying provisos, finds that an otherwise forbidden discrimination is nevertheless permitted by the statute where any one of the following three affirmative justifications spelled out in those provisos is established:

1. The discriminatory lower price is in response to changing conditions affecting the market for or marketability of the commodities involved,
2. The discriminatory lower price is made in good faith to meet an equally low price of a competitor, or
3. The discriminatory lower price makes only due allowance for specified cost differences.

The attorney necessarily concludes, from this review of the Robinson-Patman Act, that to determine whether an alleged discrimination is in violation of that Act he must resolve three negative and three affirmative issues. First, the Act requires him to determine whether any one of the three facts essential to establish an unlawful discrimination is *not* present. If any one of these facts is absent, there exists no unlawful discrimination. Second, the Act instructs him further to determine if any one of the three affirmative justifications for such a discrimination *is* present. If so, the otherwise unlawful discrimination becomes lawful. Finally, he then, in addition, mentally notes that there are certain other statutory provisions of limited application which may also require his attention, but he usually sets these to one side until the aforesaid six major factual issues have been reviewed.

The attorney, thus enlightened by this analysis of the Robinson-Patman Act, thereafter proceeds to apply his study of the law to the specific discrimination that he is to review as indicated in the following discussion.

Negative Issues

The attorney initially takes steps to resolve the negative issues of whether one or more of the three facts essential to establish an unlawful discrimination are not present. If he finds that any one of these facts is missing, he knows that the discrimination that he is considering is not forbidden by the Act.

First, he checks to see whether the discrimination under review is or is not a "discrimination in price." Thus, if he finds that his client is selling at different gross prices but, in fact, at the same net prices, he may conclude that "discrimination" is not present.[2] Again, if he determines that his client is discriminating in some manner other than in price, as, for example, by selling to a few retailers but not to others, he may decide that any discrimination involved at least is not discrimination "in price."[3]

Second, he looks to see whether the discrimination under review is or is not between "purchasers of commodities of like grade and quality." Should he determine that the persons involved do not buy directly from his client, and are not controlled by his client in buying indirectly through his client's customers, he may conclude that such persons are not "purchasers."[4] In the event that he finds any discrimination between purchasers to be in a price charged for services (which are not ancillary to any sale of a commodity), e.g., for the transportation of passengers,[5] he may decide that the discrimination is not between purchasers of "commodities." And should the discrimination consist in charging a lower price for an inferior grade of gloves and a higher price for a superior grade of this commodity,[6] he may properly conclude that there is no unlawful discrimination in the sale of commodities of "like grade and quality."

Third, he then scrutinizes the discrimination for any indication that its effect may be to "injure competition." Many price differences are so small that they could have little or no effect on "competition."[7] Other differences might "injure" competition if they discriminate between competing buyers[8] but not if they solely affect competing sellers.[9] And still others, such as functional prices giving a lower price to wholesalers than to retailers,[10] actually promote competition.

Affirmative Issues

If the attorney finds that each fact essential to establish an unlawful discrimination is present, he realizes that the discrimination under review is *prima facie* unlawful. He then seeks to determine whether or not one of the Act's three affirmative defenses justifies the discrimination.

First, he reviews the facts to see whether by chance his client has sold at a lower price to some customers than to others in response to "changing conditions" affecting either the market for or the marketability of the commodities involved. For example, his client may have differentiated in price in order to enable his customers to buy, at their election, either on a short-term or on a long-term basis.[11] Or his client may have found it necessary to dispose of distress merchandise to a few of its customers in bona fide transactions at special distress prices.[12] In either case he may conclude that any discrimination would be justified by the differing market "conditions" of the respective sales.

Second, he checks the facts to see whether his client "in good faith" has sold at a lower price to some than to others in order to "meet an equally low price" of a competitor. His client may have done so in order to meet competition for the trade in a particular area[13] or for particular customers.[14] In either event, if his client is acting "in good faith" to "meet" and not to beat competitive pricing,[15] the price discrimination would be affirmatively justified.

Third, he analyzes the facts to determine whether or not his client has sold at a lower price to some than to others

in order to make "only due allowance" for differences in the cost of selling and delivering to these customers. He soon realizes, however, that at this point he is over his head in a sea of figures and, if he is well advised, urgently calls upon the certified public accountant to throw out an accounting lifeline. It is here that the role of the accountant with respect to price discrimination commences, as more particularly discussed below.

After this examination of the key provisions of Sections 1(a) and (b), the attorney must also consider certain other portions of the Robinson-Patman Act of less general applicability which may affect his client. For example, if the discrimination is local he considers whether it is possibly exempt from the Act as not involving interstate commerce,[16] or, if he represents a buyer, he considers whether proof of lack of knowledge of the illegality of a discrimination received may not save that buyer.[17] On the other hand, he may be concerned by the possibility that sales were made at "unreasonably low prices" for the purpose of eliminating a competitor, which may be unlawful under Section 3 of the Robinson-Patman Act even though no discrimination is involved.[18] Furthermore, what he believes to be a simple price discrimination problem may, on further analysis, turn out to be in fact an allowance in lieu of brokerage or an advertising or promotional allowance, all of which are subject to different tests under Sections 2(c) and 2(d).[19]

If this last despairing search into the encircling provisions of the Robinson-Patman Act reveals no opening through which the discrimination may escape, the attorney has, of course, no alternative but to prepare himself for the ordeal of advising his client that the discrimination is caught and condemned by that Act. For this purpose he fortifies himself with a quick look at the public and private procedures for the enforcement of the Act, and discovers that the discrimination may entail investigation, litigation, orders to cease and desist,[20] treble damages[21] and, in certain extreme situations,[22] fines and jail.[23] He thereupon as tactfully as possible submits his adverse legal opinion to his client and preaches a sermon of antitrust compliance in which the conscientious desire of his client to attain antitrust perfection is strengthened by realistic fears of antitrust purgatory.

Fortunately, the attorney in many instances discovers that one or more of the various major or minor tests for determining Robinson-Patman validity does in fact apply to, and authorizes, the discrimination under review. Many reasonable forms of price differences are, of course, permitted by the Act.

Cost Justification

Statutory Provisions

Our attorney in his analysis of the three affirmative justifications for price discrimination, we have seen, will often at some point need to determine whether or not the cost savings proviso of the Robinson-Patman Act authorizes the discrimination under review.

This proviso, in effect, declares that a seller may charge a lower price to some customers than to other customers where the differential between these prices makes:

"* * * only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."[24]

The attorney upon study of this proviso, as we have mentioned, soon realizes

that he cannot unaided determine whether or not this cost savings proviso sanctions the discrimination under review. For the statutory language, in substance, requires him to apply to the discrimination a composite mix of legal and accounting principles to three challenging tasks:

First, he must discover which costs of manufacture, sale or delivery, if any, differ as the result of differing methods or quantities of sale or delivery;

Second, he must then discover the extent to which these costs of manufacture, sale or delivery differ with differing methods or quantities of sale or delivery; and

Third, he must thereupon compare any difference in price (given by reason of the differing methods or quantities of sale or delivery) with the difference in costs (resulting from these differing methods or quantities of sale or delivery), in order to determine whether or not the price differential makes only due allowance for the cost differential.

The attorney, accordingly, upon reflection, usually defers his determination as to whether the cost savings proviso justifies the discrimination at issue until he is joined by an accountant. In the processing of the three-stage analysis above outlined, two heads are clearly better than one. To paraphrase a famous legal maxim, the attorney who seeks to be his own accountant, in such a Robinson-Patman analysis, has a fool for a client.

The attorney and the accountant will, of course, begin their joint study of cost justification with the actual needs of their client in mind. These needs will tend to channelize the type of investigation that they make and prevent them from coming up with a mere academic dissertation exhibiting professional ingenuity but lacking practical utility. Nevertheless, it is important that the form in which their assignment is presented to them should not dull their alertness to the existence of other cost factors not specified (and possibly not known) by their client which may be of equal relevance to their study. For example, the cost differences which the client has in mind as justifying a possible differential may be more than counterbalanced by other cost differentials that work in the opposite direction.[25]

Frequently, moreover, the team will find it advisable to make a preliminary study to determine whether there is a reasonable likelihood that any price differential can be cost justified, before they recommend as being worth while the more elaborate, detailed and expensive study needed to prove the cost savings defense to the satisfaction of a potential court or hearing examiner.[26]

Once these preliminary phases of their work are concluded, however, the attorney and the accountant will proceed step by step to make the definitive cost study required by the statutory cost proviso. The order in which the attorney and accountant eventually proceed in determining whether the price discrimination is justified by the cost savings proviso, needless to say, is a matter to be determined by the individual experience and preferences of those parties. Whatever the order that they follow, however, the attorney and accountant will apply their complementary skills to the three-stage requirements of the cost justification project substantially as presented in the following discussion.

Cost Segregation

The attorney and accountant in the course of their work proceed at some point to segregate, from all other costs of the business organization involved, those costs of manufacture, sale and

delivery which differ as the result of differing methods and quantities of sale and delivery.

To achieve this segregation the legal and accounting co-workers initially define what they mean by "cost." Both lawyers[27] and accountants[28] recognize that words used in a statute may have special meanings which differ from their usage in other statutes. For this reason, for example, "cost" possibly may not in every Robinson-Patman proceeding mean "cost" as this term is customarily defined by accountants, but may on occasion embrace "cost" (including a return on investment) as that term is used[29] by economists. "Costs" under the Robinson-Patman Act will not, however, mean "marginal" or "incremental" costs, such as an economist will often refer to, because the savings which result from additional volume of production should be shared pro rata among all those who contribute to that volume and not be given entirely to the person who happens to be the latest purchaser.[30]

The attorney and accountant next identify those costs, so defined, which differ when "methods or quantities" of sale or delivery differ. Costs which do not differ with such differing methods and quantities are disregarded.[31] In addition, difficult questions as to certain of such costs are resolved, e.g., whether costs of production differ with a method of delivery when orders are placed with a low-cost rather than with a high-cost plant.

The joint team then ultimately segregates those costs which so differ with such differing methods and quantities, from the other costs of the business organization. Where the former are direct costs, this, of course, is not difficult. Where the former are indirect costs, however, they may only be isolated through the use of functional groupings, time studies, sampling and other accounting techniques.[32] Mere estimates[33] and past company procedures[34] for such segregation, unsupported by any factual basis justifying their use,[35] are unreliable tools for this purpose and should not be employed. On the other hand, the fact that certain costs may be "intangible"—the cost of collecting bills, and credit activities, for example —does not necessarily disqualify them.[36]

Cost Allocation

The attorney and accountant not only segregate, but at some point proceed to allocate to specific products and groups of customers, the costs thus found to differ with differing methods and quantities of sale and delivery. To do so they are required, of course, to decide what product or groups of products are to be considered as being sold and delivered by means of varying methods and in varying quantities. Usually they select a particular product as the subject of their study. On occasion, however, it is proper for them to compare the costs of complete lines of products.[37]

They also decide what customer or groups of customers are to be considered as being sold and delivered by means of those varying methods and quantities. Customers need not be considered individually but may be divided into reasonable categories.[38] Care must be taken, however, that substantially all customers taking in the same manner or quantities are placed in the same category, for otherwise purchasers lumped together indiscriminately with unlike purchasers may have costs allocated to them which they do not in fact incur.[39] For example, it is not permissible to take one large retailer of groceries and compare the costs of serving it with the costs of serving all other customers, large, small and medium.[40] Furthermore, it has been said that quantity classifica-

tions are only lawful so long as the divisions into brackets are made at breaking points which do not have a substantial anti-competitive effect and so long as the brackets are not unduly broad and the differentials not unduly great.[41]

The team of the two professions then allocates those costs which differ with differing methods and quantities of sale and delivery among the product and customer groups thus selected by them. Once more direct costs can readily be so allocated, but indirect costs can only be so apportioned by functional groupings, time studies, sampling and comparable accounting procedures. Any allocation of costs based upon arbitrary assumptions, e.g., that each customer receives substantially the same number of salesmen's calls,[42] or that all salesmen's calls last the same time[43] or that costs necessarily vary with dollar sales,[44] must not be attempted. Similarly, any allocation of costs to some and not to other products and customers equally sharing in those costs must be avoided.[45]

Cost Evaluation

Ultimately, of course, the attorney and the accountant are forced to evaluate the extent to which the difference in price represented by the discrimination under review is justified by the costs which have been segregated and allocated as above described.

At this stage of their cost project they initially define what is meant by "price." Does the term mean f.o.b. mill, mill net or a delivered price?[46] Is it a net price after cash and other discounts, or is it a gross price?[47] And how do you price a line of products?[48]

They next compare the difference in the price, thus defined, of the discrimination under review, with the above segregated and allocated costs. That is to say, the price difference of the selected product or products, when sold and delivered to the selected customer or groups of customers, is compared with the segregated and allocated costs of such product or products when thus sold and delivered.

The members of the two professions, thereupon, proceed to evaluate the results of this comparison, in order to determine whether the differences in price under review make "only due allowance" for the segregated and allocated costs. They must decide, as a matter of fact, whether the price differential is less than, equal to or more than the cost differential. They must then determine, as a matter of judgment, whether the price differential so compared is justified by those costs. In this evaluation a rule of reason must be employed,[49] and where the price differential seems in good faith to be justified by the cost differential,[50] any *de minimis* failure of minor items to be cost justified may be safely disregarded.[51]

In summary, the task force of an attorney and an accountant proceeds to "segregate," to "allocate" and to "evaluate," when they analyze an alleged price discrimination in the light of the cost proviso of the Robinson-Patman Act. In each of these three stages of cost justification there abide complex issues of fact, law and accounting; but in the third lies the greatest of these tasks. For in evaluating whether or not a discrimination under review makes only due allowance for segregated and allocated costs, the joint team must weigh impersonal cost figures on the scale of personal judgment. In Robinson-Patman Act accounting, figures don't lie; but men of good will can and do disagree widely when they figure. These disagreements may only be resolved by mutual recognition that the purpose of the cost savings proviso is to permit the passing on of the econ-

omies of mass production and low cost distribution,[52] and by mutual cooperation to ensure that all price differences genuinely conducive to achieving that objective[53] are accorded full faith and credit by the Federal Trade Commission and the courts.

Practical Suggestions

Intelligent Cooperation

The Robinson-Patman Act, it is clear, by the terms of its cost savings proviso calls for the marriage of the two professions of law and accounting; and no attorney who deals with price discrimination may lightly seek to avoid this marital status. How the parties to such a union arrange the details of their professional housekeeping will, of course, vary from happy couple to happy couple. As marital counsellor, however, the writer respectfully offers to the reader the following four practical suggestions for a successful professional life together under the hospitable roof of this Act:

The first and most obvious suggestion is that each member of this professional team should seek earnestly to understand —but as carefully refrain from usurping —the role of the other. The attorney who naively believes that cost accounting is an exact science which can produce answers with mathematical certainty should read a few basic accounting treatises.[54] Similarly, the accountant who assumes that in the field of antitrust there is necessarily a rule of law and not of men might look at some elementary antitrust publications.[55]

Their division of work, of course, will vary depending upon the necessities of the particular cost justification project. Preferably, the accountant should report to, and, if possible, be retained by the attorney so that the accountant's work may become part of the attorney's "work product."[56] The attorney and accountant might then jointly plan their cost justification study, and thereafter proceed to put their plan into operation on the assumption that the primary responsibility of the accountant is to do the work and that of the attorney is to be the armchair critic. Only the accountant has the skill permitting him to find and compile the essential data, and only the attorney has the knowledge of legal theory needed for the legal analysis of the data.

Good Faith

An equally obvious suggestion is that this cooperation between attorney and accountant should be built upon the solid rock of professional integrity. The Commission[57] and the courts[58] have repeatedly stressed that what they seek is not so much perfection as it is good faith.

The attorney and the accountant, however, must do more than profess good faith. The burden is upon them to document the justification for each step of their cost savings study. For where they fail to provide sufficient data in support of their decisions, the suspicion is inevitably aroused in Government and judicial circles that they are assuming — rather than proving — arbitrary conclusions sought by their client.[59]

If such good faith can be documented by proof rather than declared by words, the Government investigator will tend to be tolerant, the Government litigator will be inclined to be apprehensive and the Commission and court will undoubtedly be sympathetic. Where legal uncertainties as to the meaning of the Robinson-Patman Act are further confounded by the accounting perplexities of its cost proviso, confused observers are only too happy to be led by the kindly light of good will.

Advance Planning

A third, but less obvious, suggestion is that the attorney and the accountant should undertake their joint cost savings venture, if possible, before litigation appears upon the legal horizon. The principal reason why the defense of cost justification in past Robinson-Patman proceedings has usually failed[60] is—in the humble opinion of the writer—that the cost studies were in most instances prepared during, rather than before the commencement of governmental inquiry.

The cost justification study which is prepared prior to the grant of a justified price differential—and thus before any hostile scrutiny—is part of the *res gestae* and thus is unmistakable evidence of good faith. No charge can reasonably be made that such advance cost planning, as contrasted with a study made during litigation, is a mere lawyer's afterthought hastily improvised by facile accountants to give a color of legality to an arbitrary discrimination.

Such an advance cost study, however, preferably should conform to two standards. First, a record should be made that the attorney and the accountant have proceeded first to determine the maximum allowable cost savings, and only then have recommended a price differential to the extent of the proven cost savings. It would be less convincing for them to assume at the outset what price differential is to be justified and thereafter to seek evidence to substantiate it. Verdict first and impartial trial later may satisfy the judicial standards of *Alice's Wonderland*, but such a procedure does not always appeal to those trained in Anglo-Saxon legal traditions. Second, a record should further be made that—following the advance cost justification study—either accounting controls or periodic spot checks have been instituted to ensure that the price differential continues to make only due allowance for cost savings. A price differential born in the lawful wedlock of the two professions may subsequently stray from the straight and narrow path of cost justification unless watched by its parents.

Reasonable Disclosure

The final suggestion is that when a creditable cost savings study has been made, it should not be hidden under a basket when litigation is threatened. Few public or private litigators wish to tie themselves up in losing cases. As soon as a Government investigator appears on the scene in a normal case, accordingly, he should be presented with the cost study and persuaded, if possible, to divert his energies more profitably elsewhere. Similar treatment may at times also be accorded to a potential private litigator if he is not a competitor and his counsel provides convincing assurance that the cost data will be kept confidential.

Even where no cost study has been made, but there exists evidence that such a study, if undertaken, would justify a challenged discrimination, it is well to maintain close liaison with the Commission investigator and its accountants while preparing that study. At times such a belated showing of virtue has also succeeded[61] in deflecting the time and energies of the Commission's staff to more promising fields of antitrust error even after a complaint has been filed. Certainly nothing is lost, and much may be gained, by such a belated cooperative undertaking. The time to despair of any possible showing of cost justification is only when the rigor mortis of an adverse final order or judgment has set in.

It might be added that the Federal Trade Commission commendably recog-

nizes that any such cost study submitted to its staff must be kept confidential. Accordingly it is not possible to know how many investigations have been dropped due to such timely disclosures that questionable price discriminations were in fact cost justified. It is reliably reported by Commission sources, however, that many such investigations have been and presumably will, happily, continue to be terminated for this reason.

Conclusion

At the outset of this paper, reference was made to the accountant who comes upon a price discrimination. Thereafter, in the succeeding pages, the legal issues and the possible role of the accountant with respect to these issues have been described. The accountant may now ask what he may do to ensure that he will enjoy such a role in dealing with these issues.

It is respectfully suggested that the accountant best ensures that he will enjoy an accounting role with respect to a price discrimination by calling it to the attention of his client. For not only does he serve well his client when he suggests study by the latter of that discrimination and its potential problems, but he may also thereby serve himself well. His client's attorney, upon review of the discrimination, will in many cases be forced—through lack of accounting skill—to reciprocate by calling in the accountant to assist him in analyzing the cost justification issues thereby raised. By throwing bread upon the client's waters, therefore, the accountant may eventually be rewarded many-fold.

By thus calling his client's attention to the price discrimination, moreover, the accountant has the added satisfaction of serving the public interest. Antitrust enforcement depends less upon the loud trumpets of public litigation than upon the still small voice of private compliance. Every doubtful discrimination that is caught in the board room means one less protracted proceeding to be fought, at public and private expense, in the court room. The accountant who enables his client to correct such an antitrust error in painless privacy, it follows, contributes materially to effective and inexpensive antitrust enforcement.

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57. *Minneapolis-Honeywell Regulator Co.*, 44 F. T. C. 351, 394 (1948), rev'd on other grounds, 191 F. 2d 786 (7th Cir. 1951), cert. dismissed, 344 U. S. 206 (1952); *Sylvania Electric Products, Inc.*, F. T. C. Dkt. No. 5728 (1954); *Kraft-Phenix Cheese Corp.*, 25 F. T. C. 537, 546 (1937).

58. See *Reid* v. *Harper & Bros.*, 235 F. 2d 420 (2d Cir. 1956), cert. denied, 352 U. S. 952 (1956); *Russellville Canning Co.* v. *American Can Co.*, 87 F. Supp. 484, 496 (W. D. Ark. 1949), rev'd on other grounds, 191 F. 2d 38 (8th Cir. 1951).

59. *Standard Oil Co. of Ind.*, 41 F. T. C. 263 (1945) and 43 F. T. C. 56 (1946), modified, 173 F. 2d 210 (7th Cir. 1949), and rev'd on other grounds, 340 U. S. 231 (1951); *C. E. Niehoff & Co.*, F. T. C. Dkt. No. 5768 (1955), modified, 241 F. 2d 37 (7th Cir. 1957), rev'd on other grounds, 18 CCH Sup. Ct. Bull. 433 (1958); *Standard Brands, Inc.*, 29 F. T. C. 121, 151 (1939), 30 F. T. C. 1117 (1940), 46 F. T. C. 1485 (1950), aff'd, 189 F. 2d 510 (2d Cir. 1951).

60. REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS, (1955) 171.

61. *Hamburg Bros., Inc.*, F. T. C. Dkt. No. 6721 (1958); *Horlicks Corp.*, 47 F. T. C. 169 (1950).

Auditing Standards

Auditing standards are the underlying principles of auditing which control the nature and extent of evidence to be obtained by means of auditing procedures. They are broad in scope, and concern both the CPA's personal qualifications, and the quality of his work. Whereas auditing *procedures* must be varied to meet the requirements of the particular engagement, *standards* to be observed in selecting and applying the procedures are the same in all examinations.

The circumstances that exist in each audit engagement require differences to a greater or lesser degree in the auditing procedures that should be employed, the manner in which they should be used, and the extent to which they should be applied. These differences make it impossible to lay down a uniform program of procedures which would be generally satisfactory. The program of procedures for any particular engagement is developed through the exercise of the experienced judgment of the CPA. This philosophy is summed up in the standard audit report in the words: "Our examination . . . included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

The AICPA, 40 QUESTIONS AND ANSWERS ABOUT AUDIT REPORTS, 1956

New York State Tax Forum

Guest Editor—Oscar Hanigsberg, C.P.A.

A favorite indoor sport of New York State accountants is complaining about differences existing between the state and federal income tax statutes. Certainly the differences make for pesky and time-consuming office routine. Sometimes the differences explode — with results much more drastic than just pesky. This is apt to happen when the eyes are focused only on the federal tax picture. Because one basis of computing the franchise tax is "the entire net income which the taxpayer is required to report to the United States" the problem is not acute in the corporation area. But individuals, Beware!!

Installment Sales

An individual reporting on a calendar-year basis sells a building for $100,000, the terms of payment being $25,000 by note payable January 21 of the following year, the balance by an amortizing mortgage. Under present federal law the transaction may be reported as an installment sale. Not so the State. Regulations Article 488-a (which covers sales of real property) states, "If the entire purchase price is to be paid in a lump sum in a later year, there being no payments during the first year, the income may not be returned on the installment basis." This regulation is identical with the federal regulation applying to pre-1954 law. The quoted language is not part of Regulations Article 487-h covering casual sales of personal property which states merely that gain may be returned on the installment basis "provided the initial payments do not exceed thirty per centum of the purchase price." Similarly the quoted language was not included in the federal regulation applying to pre-1954 casual sales of personal property.

In *Frank H. Gilbert* (C.C.A. 9, 2/15/57), the government took the position that a sale of stock, the price to be paid in eight equal installments, did not qualify as an installment sale because there was no payment in the taxable year in which the sale occurred. The government argued that the failure to include the quoted language in the regulations governing personal property sales was due only to "poor draftsmanship", pointing out that the reasoning upon which the regulation dealing with sales of real estate was based was equally applicable in the case of sales of personal property. The Court of Appeals reversed the Tax Court which had upheld the government (25 TC 81) and stated: "The intrinsic unreasonableness of a provision which would visit such harsh results upon one who has not received a nominal initial payment is enough to render suspect the reasoning which finds such an implied requirement." It accordingly refused to apply the real property test to a sale of personal property.

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Ed. Note: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

Election as to Recognition of Gain in Certain Liquidations

Federal law (Code Section 333) provides an election to liquidate a corporation in a manner which has the effect of permitting the receipt by stockholders of property which has appreciated in value, without the recognition of gain on such appreciation. Under this method stockholders are taxed with an ordinary dividend to the extent of accumulated earnings, but with no capital gain except to the extent that cash (and securities acquired by the corporation after December 31, 1953) distributed to the stockholders exceeds the amount which has been taxed as a dividend. The election is of particular value in the case of real estate corporations which may own property worth far in excess of cost. Earned surplus in such corporations is often relatively small because of depreciation charges. The liquidation of such a corporation may be desired preparatory to selling the property. Without such a liquidation, the stockholders cannot enjoy the benefit of reporting the gain on the installment basis.

Present State law provides no comparable election. The election did exist during the years 1951 and 1952 (Tax Law Section 354(9)) but has never been made to apply to later years. Consequently, the ordinary rules apply and the full appreciation would have to be accounted for in the value of the liquidating dividend. Furthermore, if it were a real estate corporation which was being liquidated, it would be liable for an additional tax of 2 per cent of the corporation's actual net worth (which includes appreciation) in excess of paid-in capital.

Dividing a Corporation

Sometimes stockholders of a corporation, after living together for some time, have learned not to love each other and seek a parting of the ways. If fortuitously the corporation, either directly or through a subsidiary, has been operating more than one business and if the stockholders are willing to split by allocating a separate business to a separate group of stockholders, federal law (Code Section 355) permits this to be done tax-free. It is not necessary for distributions to stockholders to be pro rata if all other requirements of the law are met. This feature is an innovation of the 1954 Code.

The State has not followed suit. To be tax-free the state law requires that the stockholders of the old corporation maintain a proprietary interest in each of the successor corporations. The state tax may, of course, be a small price to pay for divorce.

Statute of Limitations on Claims for Refund

No matter when a federal income tax has been assessed, a claim for refund of the tax paid is always timely if it is filed within two years from the date of payment. Under state law, delayed payment never acts to extend the time for filing a claim. The limitation period is two years from the date of filing the return or payment of tax, whichever is earlier. If the tax has been recomputed by the Tax Commission, the law allows one year from the time the recomputation is made.

There is a possibility of extending the period for claiming refunds through the operation of Tax Law Section 367.2 which requires the taxpayer to notify the state of any federal changes. If a timely federal claim can be filed and a federal determination secured, on proper notification the Tax Commission will authorize a refund notwithstanding the limitation of time which might otherwise bar the refund (Regulations Art. 571-a). It may be possible, therefore, to get in the back entrance after the front door has been locked.

Accounting at the SEC

Conducted by Louis H. Rappaport, C.P.A.

The Recession and Adverse Changes

As might be expected, the SEC is keenly aware of the much publicized current recession in business. Although the Commission requires financial statements filed with it to be as of a date within 90 days of filing in some cases and within six months of filing in others, the SEC is alert to the fact that recent developments in the affairs of a company may give a picture quite different from that exhibited in the financial statements required to be filed.

A high-grade industrial company filed a registration statement with the SEC covering an issue of debentures in March, 1958. The company is on a calendar year for fiscal reporting purposes, and the financial statements filed were as of December 31, 1957 and for the five fiscal years then ended. These statements complied with the requirements for financial statements in the applicable registration form. In due course the Commission issued its memorandum of comments which contained the following comment in relation to the summary of earnings:

> If net sales and net income for the three months ended December 31, 1957 were materially below those for the same three months in the preceding year, it is suggested that such figures on a comparative basis for the two three-months periods be given.

The obvious purpose of this comment was to elicit information with respect to a material dip in sales or net income in the last quarter of 1957 as compared with the corresponding quarter of the preceding fiscal year. Accountants would be well advised to keep in mind the matter of recent adverse changes in the financial affairs of a company even though the formal requirements of the SEC do not specifically call for such current information.

Trial Balances of Brokers and Dealers

The SEC has under consideration a proposal to amend one of its rules under the 1934 Act. The rule in question (designated 240.17a-3) specifies the books and records which must be maintained and kept current by certain members of a national securities exchange, brokers and dealers. The amendment would require such persons to prepare a record of the proof of money balances of all ledger accounts in the form of trial balances as of a date approximating the last day of each month.

The principal purposes of such trial balances would be to serve as a check upon the current status and accuracy of the ledger accounts which members, brokers and dealers are required to maintain and keep current, and to assist in keeping such members, brokers and dealers currently informed of their

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capital positions. The SEC believes that maintenance of such trial balances should also reduce the number of violations of bookkeeping and capital rules which are found to exist. The Commission is informed that most members, brokers and dealers already prepare such trial balances as a part of their regular bookkeeping procedures.

The Commission proposes to add a new subparagraph (11) at the end of the existing rule. The new paragraph would read as follows:

> A record of the proof of money balances of all ledger accounts in the form of trial balances. Such trial balances shall be prepared currently at least once each month as of a date approximating the last day of the month.

The Commission has invited interested persons to submit their views and comments on or before May 1, 1958. We believe that the Commission would also welcome comments received within a reasonable period after that date.

Amendment of Rule 2-01 of Regulation S-X

The complete text of Accounting Series Release No. 79, issued April 8, 1958, is reprinted below.

On January 28, 1958, the Securities and Exchange Commission announced that it had under consideration certain proposed amendments to Rule 2-01 of Regulation S-X (see Securities Act Release No. 3893). The Commission has considered all of the views and comments received on the proposals and has adopted the amendments in the form stated below.

Purpose of Amendment

When the Committee on Banking and Currency of the United States Senate was holding hearings on the Securities Act of 1933, a representative of the accounting profession appeared before the Committee and suggested requiring certification by independent public accountants of financial statements included in the registration statements under the Act. The committee considered at some length whether the additional expense to industry of having an impartial audit by accountants independent of the company and management was justified by the expected benefits to the investor and the public. The proposal to require certification by independent public accountants was incorporated in the principal statutes administered by this Commission, either as a requirement or as authority to require certification.

The Commission in the past has considered that relationships such as promoter, underwriter, voting trustee, director, officer, and employee of, and ownership of any direct or indirect financial interest in, the registrant or any affiliate thereof were incompatible with the independent status of a certifying accountant. The Commission has therefore refused to recognize an accountant as independent with respect to any person with whom he has any one of these relationships. Since certification by an independent accountant is required because of the value of an independent review, we believe that the prohibition of these relationships is justified and should be continued. However, in the ascertainment of whether accountants or members of their families have entered into one of these relationships with remote affiliates of the persons whose statements are being certified, and whether, in some instances, they hold indirectly any financial interest in the registrant or any of its parents or subsidiaries, there is an area in which some latitude for judgment is necessary in order to avoid undue hardship and expense to registrants and to accounting firms having a widespread accounting practice or whose clients have numerous affiliates. We have

therefore revised the rule to permit the application of a test of materiality to these borderline areas. The change in the rule does not permit any of these relationships with close affiliates as we consider such relationships to prejudice materially the independent status of an accountant.

Situations arise in which it is not necessary to make a finding of lack of independence even though an accountant may have held a financial interest during the period of report but at a time when his independence was not a factor. For example, an accountant may be called upon to furnish a certificate in a registration statement for a former client in whom he now has a financial interest but with whom he maintained an independent relationship during the period covered by the audit and up to the date he issued his original certificate. Another example is where an accountant held stock in a company for which he had never had an engagement but sold it upon accepting an engagement. In these and other situations where it is clear from the facts that the independent status of the accountant is not prejudiced by a particular relationship, we will upon request advise the accountant that no action will be taken because of this relationship.

The rule has also been revised to make it clear that where the relationships described in the rule exist the Commission finds that an accountant is in fact not independent with respect to the company involved but does not find that he is in fact independent in instances where it fails to find that one of these relationships exists.

These revisions give formal recognition to administrative practices which have been in the process of development for some time. They make no material change in the policy as enumerated in prior decisions of the Commission and in published opinions of the Chief Accountant.

Text of Amendment of Rule

The amendments are in the form of a revision of paragraphs (b) and (c) of Rule 2-01. The paragraphs as amended read as follows:

"(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Statutory Basis

The foregoing action is taken pursuant to the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof, the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14, and 20(a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, 31(c) and 38(a) thereof.

Since the revision clarifies the rule to reflect interpretations now in effect, it shall become effective April 8, 1958.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Fees for Audits of Non-Profit Organizations . . . Relieving the Overburdened Practitioner . . . Uncle Sam's Wonderhouse of Information . . . How To Read Technical Literature Most Beneficially.

Fees for Audits of Non-Profit Organizations

At the technical meeting of the Committee on Administration of Accountants' Practice, a paper on the subject of fees was presented by Jack Goldner, CPA. A comment on one of Mr. Goldner's references, made by Robert M. Leng, CPA, is here published because it offers a sound solution to a problem that concerns a very large segment of our profession.

"Most accountants are faced from time to time with requests to examine the accounts of religious institutions, hospitals, fund-raising campaigns, etc. Usually there is little desire or, for that matter, ability on the part of such an organization to pay a fee of any size regardless of the amount of work involved. Frequently also there is a considerable amount of work involved because the records of such organizations are not always of the best quality. No reputable certified public accountant would, I hope, take such an engagement on the basis of doing a slipshod piece of work in order to keep the fee down. We should, however, recognize that we have an obligation to do our part in community affairs and in one way or another we must materially reduce our fees. Fortunately, arrangements can usually be made to do such work at our convenience in a slack time of year.

"The principal question, then, is the mechanics of reducing the fee. Several methods are followed in this respect. One is to agree to do the work for a flat amount regardless of time or cost involved. Hopefully but not necessarily, this can be set at a level which will cover anticipated direct costs. Another method is to agree to bill at cost or at a predetermined reduced rate per day; a third method is to bill at normal per diem rates with an understanding that any excess over a predetermined amount will be refunded by the certified public accountant as a contribution to the organization. I know of no strong preference for any one of these methods from the point of view of the CPA. From the point of view of the

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charitable organization and particularly one which operates on a budget, the predetermined flat fee is the most satisfactory."

Relieving the Overburdened Practitioner

Responses to the request for ideas on how to relieve the overburdened practitioner are still being received. Not all replies need be quoted fully because of duplication of data. Distinctive expressions from several letters are here submitted because of their interest.

One courageous individual practitioner gets relief by this process:

"My own philosophy hardly will be found palatable to many of our members. I have always upgraded my practice by weeding out the clients who were less desirable from my point of view. In this way, we have managed to confine the practice to the maximum which we can accommodate comfortably and intelligently."

A partner of a large national firm pointed out the following:

"Within recent months we have appointed an office manager who will handle a great many of the administrative details and will be the contact between the partners, in their handling of administrative matters, and the nonprofessional staff. While it is a fact that the office manager carries a heavy burden, it is true that he has relieved the practicing partners and matters do run more smoothly. While the change may have limited applicability because of the size of our office, it indicates to me the desirability of having responsibility for administrative matters channel through one person."

Another practitioner benefited substantially from this action:

"We have solved the problem in our office by turning over to our senior staff members the detailed review of reports."

This is what a very important, busy practitioner reported as being very helpful to him:

"I have long felt that one of the greatest problems a busy partner has, is to take care of 'interruptions' which seemed to me to cause substantial loss of time because of the necessity of getting a fresh start on what was being attended to before each interruption. To the end of reducing interruptions to a minimum, I now look at incoming mail, and other material that requires my attention, only twice a day—once in the morning and once in the late afternoon, with my secretary being charged with the responsibility of bringing to my attention immediately at any time during the day any matter that, in her judgment, requires prompt action. This has saved me a great deal of time."

But it is a sad commentary on the state of overburdenment of practitioners that one-half of the men approached for information about four months ago are so overloaded that they have not been able to find time to even acknowledge receipt of the inquiry.

Uncle Sam's Wonderhouse of Information

Accountants who are on the free mailing list of the Superintendent of Documents receive frequent mailings of lists of pamphlets and books obtainable from the Government Printing Office, Washington 25, D. C. The lists contain material on the most diverse subjects, from baby and plant care to nuclear fission and fusion. From this huge outpouring of material can be culled items of interest to accountants. Moreover, the prices for the pamphlets generally range from 15 to 50 cents each, making them attractive from a cost viewpoint.

The last catalogue included a section of pamphlets for businessmen, secretaries, stenographers and typists. Illus-

trative of the subjects covered are the following:

Writing Out Loud (Ideas for improving dictation; 15 cents).

Cutting Office Costs in Small Plants (25 cents).

Getting your Ideas Across Through Writing (20 cents).

Correspondence Manual (Mechanical aspects of letters; 40 cents).

These pamphlets may be useful to accountants and to many of their clients. A supplementary list of publications contained a pamphlet entitled "A Guide to Promotion and Publicity for an Effective Incentive Awards Program" (40 cents). Accountants concerned with management advisory services might find this pamphlet helpful. To get onto the mailing list for the catalogues just write to the Superintendent of Documents at the Government Printing Office, Washington 25, D. C.

How to Read Technical Literature Most Beneficially

Accountants are constantly beset with the problem of coping with a mountain of literature that should be read. In recognition of this worsening condition there have sprung up courses in rapid reading and literature on the subject. The possibilities of increasing reading speed were mentioned in this department in the August 1953 issue.

However, some authorities warn against the blanket adoption of speed reading particularly where the subject matter is technical and thought provoking. One of these authorities is Prof. Mortimer J. Adler of Chicago who some years ago wrote a book entitled "How to Read a Book." He contends that there is no fixed rate of speed for intelligent reading and that the efficient pace is one which, in the individual instance, permits the intelligent absorption of the material.

He has also furnished a few pointers on how to read and achieve the maximum absorption of the material. One major recommendation is very simple —merely the underlining or otherwise singling out of significant expressions. This idea, and others, are here described, in outline form.

Why marking up a book is indispensable.

1. It keeps you awake.

2. Reading should also be thinking —and thinking tends to express itself in words, spoken or written.

3. Writing helps you remember the points you are desirous of retaining or the thoughts that occurred to you as you read.

Ways to mark a book

1. Underlining words, phrases, sentences.

2. Vertical lines at the margins—for emphasis, reference of material underlined.

3. Star or asterisk at the margin (use sparingly) to indicate a most important statement.

4. Numbers in the margin—to indicate sequence of points the author makes.

5. Numbers of other pages—note on margin references to pertinent material on other pages.

6. Circle key words or phrases.

7. Notations in the margins, top or bottom of the page recording questions, disagreements, summarizing a lengthy dissertation, recording sequence of major points, etc.

Use of scratch pad

If you don't want to mark up a book, use a scrap pad for the same purposes and insert the sheets permanently inside the front and back covers of the book.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance Law Amendments of 1958

On March 26, 1958, Chapter 387 of the laws of 1958, amended the labor law in relation to benefit rate, original claim, general account, experience rating, employer appeal fees, and disqualification under the unemployment insurance law. Not all of these amendments to the unemployment insurance law go into effect at the same time. Effective dates range from July 1, 1957 (a retroactive date with reference to the increased benefit amount categories) to June 30, 1959 (applicable to the crediting of taxes paid by employers on dismissal and student wages to the employer's individual account). These are the areas in which the unemployment insurance law was amended by the omnibus bill:

1. The maximum for unemployment insurance benefits was raised to $45 per week by providing for nine new higher benefit categories of $37 to $45 with the requirement that there be a 50 per cent ratio between benefit amount and average weekly wage up to $90 a week.

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Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

Since this amendment is retroactive to July 1, 1957, claimants whose average wage was $73 a week or more and who began their current benefit year July 1, 1957, will be entitled to retroactive payments. Accountants should inform their clients of the immediate necessity of responding promptly to the requests from the unemployment insurance department for added payroll and employment information. Failure to respond within the required 7-day period will result in the imposition of a $10 penalty for each late reply. The state will require data from 200,000 employers for retroactive benefit payments for former employees separated as long as two years ago. Of course, these retroactive benefit payments will be included on form IA 96, and will affect the client's experience rating.

2. The definition of "effective day" as set forth in Section 523 of the unemployment insurance law was changed so as to provide that no "effective day" is deemed to occur in a week in which the claimant has days of employment for which he is paid compensation exceeding $45 instead, as formerly, $36. This provision went into effect March 31, 1958.

3. In addition to the present requirement under Section 527 that a claimant must have worked 20 weeks with earnings averaging at least $15 a week, a claimant will become eligible if he has 15 weeks of work in a preceding year and 40 weeks work in the two years preceding the date of filing his

claim, with average weekly earnings of at least $15.

4. If a common issue exists, appeals by an employer in a number of similar cases involving payment of benefits to various employees may be made to either a Referee or to the Appeal Board, upon the payment of a single appeals fee under Section 621 (1).

5. A new subdivision (3) of Section 591 provides that if there is a bona fide vacation period with or without plant shutdown, a claimant is ineligible to the extent that he receives vacation pay, if he was substantially fully employed by his employer in the last week before and in the first week after such period. The vacation pay must be given directly to the claimant by his employer. The significance of this requirement is that vacation pay, although it may be derived from monies supplied by the employer, will not render a claimant ineligible if it is payable from a fund, such as a union fund or an intermediary, and claimant is otherwise entitled to benefits.

6. Uniform disqualification periods (that may not be broken by subsequent new employment following loss of employment as a result of strikes, voluntary quits, misconduct, and refusal to work) are established by amendment to Section 593 which becomes effective June 30, 1958. A disqualification period is an unbroken one of six weeks from date of separation or refusal of work. Subsequent employment *after* claim is filed will not, as at present, eliminate the disqualification.

7. Taxes on students and others not eligible for benefits, and on dismissal wages which the employer is not otherwise obligated to pay, shall be credited to the individual employer's account for experience rating credit, starting on and after June 30, 1959. This is provided for in an amendment to Section 581 subdivision (1) paragraph (m). At the present time payments of such contributions are credited to the "General Account."

8. Higher unemployment insurance tax rates commencing January 1, 1959 are provided by the law which did not alter the rates for the year 1958 which range from .6 per cent to 2.8 per cent including the .1 per cent subsidiary tax. In some instances, employers with more favorable experience rating records may be assigned lower rates than under the present year's rating system. However, because of the present heavy drain on the unemployment insurance benefit fund, it is more likely that even positive-account employers with favorable experience rating records will be required to pay contributions at even higher rates because the determination factor, which is the size of fund index percentages, have been changed by the amendment to Section 581 subdivision (2) of the law. For positive account employers in 1959, the rates will range from .7 per cent to 2.9 per cent of taxable payroll which is the first $3,000 in wages paid to an employee by his employer during a calendar year.

9. Employers who are delinquent in filing all prescribed reports by September 30, 1958 and by the September 30th date in subsequent years, will be required to pay contributions at a rate of 3.0 per cent of their taxable payrolls for the following taxable year regardless of how favorable their experience rating status may otherwise be. Under this provision an employer who might have otherwise been assigned a rate of .7 per cent could be saddled with a 3.0 per cent rate because of this amendment to Section 581 subdivision (2) paragraph (b). Accountants must take precautions to avoid assessment at the 3.0 per cent rate because of delinquency in filing *all* prescribed reports. This Section is not limited to the filing of contribution reports but encom-

passes other reports required to be filed as prescribed by the Industrial Commissioner.

10. Negative Account employers' contribution rates will be 3.0 per cent in 1959 if their individual employer accounts show a negative balance on June 30, 1958 or for the first time the account becomes negative on any June 30th thereafter. The rate will increase to 3.2 per cent if the account registers a negative balance for two or more consecutive years.

11. An annual chargeoff of all "negative account" balances will be made above 2 per cent of payroll, by debiting the same to the General Account, as a result of the amendment to paragraph (e) of subdivision (1) of Section 581. Such employers with small negative balances will thus be able to eliminate the balance by the amount of its contribution in the following year. This amendment is effective June 30, 1958.

12. Benefit charges in reverse chronological order will be made to employers' accounts and not to the General Account as at present, for benefits paid to claimants for more than 15 or 20 weeks (as the case may be) in a benefit year. This amendment was made to Section 581 subdivision (1) paragraph (e), and becomes effective June 30, 1958.

13. A new method of determining the subsidiary tax will go into effect June 30, 1959 and will affect rates starting with the taxable year January 1, 1960. It will be invoked in case the balance in the General Account falls below $100 million. The effect of the new "diversion" from each employer's account to replenish the General Account may range from .1 per cent to .5 per cent of the employer's taxable payroll for the preceding calendar year and would have the effect of increasing the employer's tax rate by .1 per cent or .2 per cent depending upon which tax rate is applicable. Provision is also made for a further range of five additional subsidiary tax rates to be added to the employer's experience rate if the General Account balance should drop below $100 million. These rates would range from .2 per cent to 1.0 per cent if the General Account balance falls below $50 million. This amendment was made to Section 577 subdivision (5) and becomes effective June 30th, 1958.

A change is also made by making charges to the General Account beginning June 30, 1958 instead of July 1, 1958, with 75 per cent of the negative balances written off on July 1, 1957 credited to the General Account and debited to an escrow account. Thereafter, one-third of the amount charged to the escrow account will be charged to the General Account over a three-year period commencing June 30, 1959, in order to bring the General Account in balance up to the computation date of the current year, instead of being a year behind.

The separate bill Assembly Introductory No. 4360 authorizes the Industrial Commissioner to enter into an agreement with the federal government so as to provide for unemployment insurance benefits for more than 26 weeks of unemployment, in the event the federal government passes such legislation. This is part of the effort by the State to combat the ill economic effects of current recession layoffs involving claimants who have exhausted their 26 weeks of benefits under the present law.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Business Expenses . . . Tax Court Procedure . . . Treatment of Containers . . . Research and Experimental Expenditures . . . Constructive Dividend . . . Proof of Source of Income: Net Worth Method.

Business Expenses

The "proposed regulations" with respect to the substantiation of employees' traveling and other business expenses do not appear to make any real change in procedure, despite the tumult and the shouting. In brief, the regulations segregate taxpayers into 3 categories:

1. Those employees who incur only incidental expenses, such as office supplies for the employer or local transportation in connection with an errand, are not required to prove such amounts or to report them.

2. Those employees incurring expenses for which they must account to the employer, including travel, transportation, entertainment and expenses for similar purposes, need not report the reimbursement as income. Where such expenses are charged directly or indirectly to the employer, it also is not necessary that these expenses be reported as income. However, the taxpayer must state in his return that the amounts received from the employer or charged to him do not exceed the ordinary and necessary business expense paid or incurred by the employee. In case the total reimbursed exceeds such expenses, the employee must state on his return that the excess is included in income.

3. Expenses for which the employee does not have to account to his employer, including regular allowances, periodic advances, etc., must be reported as income on the return. The expenses paid or incurred by the employee are deducted separately. A statement must be submitted showing the nature of the employee's occupation, the number of days away from home on business, and a breakdown of the expenses into broad categories.

The "proposed regulations" suggest methods of substantiation for the expenses, and, further, leave much to an examining officer's discretion with regard to those expenses for which substantiation cannot ordinarily be obtained. This, of course, is no great change from prior procedures. It has long been required that allowances and advances for which the taxpayer does not have to account, be reported by the employer on information form 1099

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(See T. D. 5480, 1945 C. B. 234; Sec. 29.147-2 of Regs. 111; and Sec. 39.147-2 of Regs. 118).

There is still left open the moot question of taxing to an officer-stockholder disallowed business expenses of a corporation. It is probable that the accounts of officer-stockholders, whether on an allowance basis or a reimbursement basis, will be carefully scrutinized since, ordinarily, the vouchers submitted by such officer-stockholders, are not subject to approval by other employees.

Tax Court Procedure

Despite the extreme care and painstaking attention which is usually expended upon a taxpayer's petition to the Tax Court, the general custom of the Treasury has been to issue a flat denial, without elaboration, reason or explanation, to each of the allegations and pleadings. Indeed, at times it would appear that the government denies the existence both of the petition and the taxpayer. And in cases involving fraud, where it has the burden of proof and must make affirmative pleadings, the government has been loathe to supply the facts and explanations underlying its assertions of understatements of income. Obviously, both of these practices have effected a considerable disadvantage to the taxpayer.

Murray L. Rachlin, CPA, has called to our attention that three recent actions by the Tax Court appear to indicate a trend to correct this situation.

In a civil fraud case, *Commissioner v. Licavoli* (CA-6, 2/14/58), the Sixth Circuit upheld a memorandum decision of the Tax Court (T. C. Memo 1956-187) which in effect struck from the record the Commissioner's answer because of his failure to comply with the Tax Court's order to explain his computation of the alleged understatement of income. The Sixth Circuit stated:

> . . . Such disclosure would enable the taxpayer to concede the claim or make an issue thereof with respect to each piece, and thus not only expedite the case but afford the taxpayer the opportunity of preparing to meet only such issues as are actually involved . . .

Were this policy limited to fraud cases alone, it would be noteworthy, but it also has been extended to cases where the sole burden of proof rests upon the taxpayer.

In a "Memorandum to Accompany Order" granting petitioner's motions in two Section 722, IRC 1939 cases (*Appalachian Electric Power Co.* Docket No. 63152/3 and *The Ohio Power Co.* Docket No. 63394), the Tax Court required the Commissioner to answer specifically, where possible, the allegations of the petitions involved. The Court condemned the Commissioner's position, observing that the Commissioner

> . . . has a duty here to admit all facts, the truth of which he knows or can readily ascertain, and if his admission must be qualified, he should make it that way, rather than deny categorically . . .

Treatment of Containers

The Commissioner has ruled that large, durable containers used to ship a taxpayer's product to its customers constitute property used in its trade or business, subject to allowance for depreciation, where the containers are returnable within a specified period, where title remains in the taxpayer, and where the deposit thereon will be refunded. However, with regard to those containers which are not returned (in this ruling, approximately 10 per cent), the difference between the deposit retained as forfeit by the taxpayer and the adjusted basis of the containers is held to constitute ordinary income or loss, as the case may be.

The rationale is that, although containers represent property used in trade or business for purposes of deprecia-

tion (Sec. 167, IRC 1954), "it does not necessarily follow that they are subject to the treatment provided for in section 1231 of the Code merely because they are property used in the taxpayer's trade or business and held for more than six months."

The Commissioner derives this conclusion from G. C. M. 6630 (VIII-2 C. B. 179), published in 1929, which holds that a taxpayer may be engaged in more than one trade or business if it is regularly carried on; and the statement by the Supreme Court in *Corn Products Refining Co.* v. *Com.* (1955, 350 U. S. 46) that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss" and that Section 117 (j) IRC 1939 (similar to Sec. 1231 IRC 1954) must be "applied narrowly" to exclude normal sources of business income. The Commissioner then applies the holding in *Nehi Beverage Co.* (1951, 16 TC 1114), although the facts in that case were different, to determine that the "sale" of the containers constitutes a normal source of income taxable as ordinary gain or loss (Rev. Rul. 58-77, IRB 1958-10, 10).

Research and Experimental Expenditures

The Commissioner has previously ruled that where a taxpayer elects to deduct circulation expenditures under Section 173, IRC 1954, for tax purposes, it is not necessary that its books reflect that treatment (Rev. Rul. 57-526, IRB 1957-45, 12).

He now extends such permission to the treatment of research and experimental expenditures. Where, pursuant to Section 174, IRC 1954, a taxpayer elects to treat such expenditures as deductions in the year in which they are paid or incurred, it may nevertheless capitalize them on its books and records. The ruling intimates, however, that it will be incumbent upon the taxpayer, in such a case, to maintain records reconciling the figures on its books with the figures on its return. (Rev. Rul. 58-78, I. R. B. 1958-10, 13.)

Constructive Dividend

In the case of a corporation which is formed to own and operate an apartment house, in which stockholders of the corporation are allowed by the corporation to rent an apartment in the project at a rental which is less than that charged to the general public, the amount by which the fair market value of the apartment rental exceeds the amount charged to the stockholders, constitutes dividends to the stockholders. This excess is includible in the gross income of the stockholders as a dividend to the extent to which it may be derived from the corporation's earnings and profits. (Rev. Rul. 58-1. I. R. B. 1958-1, 24.)

Proof of Source of Income: Net Worth Method

In the case of *Holland* v. *U. S.* (1954, 348 U. S. 121), the Supreme Court had promulgated a doctrine that proof by the government of a "likely" source of unreported income was sufficient to convict for tax evasion under the net worth method, even though the government did not negative all the possible nontaxable sources of the net worth increase.

In a recent "per curiam" opinion, it points out that the principles enunciated in the *Holland* case do not preclude conviction under the net worth method where all possible sources of nontaxable income are negatived. It states: ". . . should all possible sources of nontaxable income be negatived, there would be no necessity for proof of a likely source . . ." (*U. S.* v. *Massei*, S. Ct., 3/3/58.)

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